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Errors undoubtedly remain. The raw transcripts were not fully edited for accuracy at the time they were produced because they were intended only as an aid to the Secretariat in preparing the records of the Committee's policy actions. The edited transcripts have not been reviewed by present or past members of the Committee.

Aside from the editing to facilitate the reader's understanding, the only deletions involve a very small amount of confidential information regarding foreign central banks, businesses, and persons that are identified or identifiable. Deleted passages are indicated by gaps in the text. All information deleted in this manner is exempt from disclosure under applicable provisions of the Freedom of Information Act.

Meeting of the Federal Open Market Committee

February 12-13, 1985

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, February 12, 1985, at 2:30 p.m. and continuing on Wednesday, February 13, 1985, at 9:30 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Corrigan, Vice Chairman
Mr. Boehne
Mr. Boykin
Mr. Gramley
Mrs. Horn
Mr. Martin
Mr. Partee
Mr. Rice
Ms. Seger
Mr. Wallich

Messrs. Balles, Black, Forrestal, and Keehn, Alternate
Members of the Federal Open Market Committee

Messrs. Guffey and Morris, Presidents of the Federal
Reserve Banks of Kansas City and Boston,
respectively

Mr. Axilrod, Staff Director and Secretary
Mr. Bernard, Assistant Secretary
Mrs. Steele, Deputy Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Oltman, Deputy General Counsel
Mr. Kichline, Economist
Mr. Truman, Economist (International)

Messrs. Burns, J. Davis, Kohn, Lang, Lindsey,
Prell, Siegman, and Stern, Associate Economists

Mr. Sternlight, Manager for Domestic Operations,
System Open Market Account
Mr. Cross, Manager for Foreign Operations,
System Open Market Account

Mr. Coyne, Assistant to the Board of Governors
Mr. Roberts, Assistant to the Chairman, Board of Governors
Mr. Gemmill, Staff Adviser, Division of International
Finance, Board of Governors
Messrs. Jones 1/ and Teplin 1/, Economists, Division of
Research and Statistics, Board of Governors
Mrs. Low, Open Market Secretariat Assistant,
Board of Governors

Messrs. Gainor and Garbarini, First Vice Presidents, Federal
Reserve Banks of Minneapolis and St. Louis, respectively

Mr. Fousek, Executive Vice President, Federal Reserve Bank
of New York

Messrs. Balbach, Bisignano, T. Davis, Parthemos, Scheld,
and Ms. Tschinkel, Senior Vice Presidents, Federal
Reserve Banks of St. Louis, San Francisco, Kansas City,
Richmond, Chicago, and Atlanta, respectively

Ms. Clarkin, Messrs. Judd and McNees, Vice Presidents,
Federal Reserve Banks of New York, San Francisco, and
Boston, respectively

1/ Attended portion of meeting on Tuesday and Wednesday related to
consideration of the Committee's longer-run objectives for monetary
and credit aggregates.

Transcript of Federal Open Market Committee Meeting of
February 12-13, 1985

February 12, 1985--Afternoon Session

CHAIRMAN VOLCKER. If we can come to order, the first item of business is electing the Vice Chairman.

MR. MARTIN. Mr. Chairman, after surveying the membership of this group and thinking of various outsiders who might [unintelligible] a change in the law, I conclude that I wish to nominate Gerald Corrigan as the Vice Chairman of the Federal Open Market Committee.

MR. RICE. Second.

CHAIRMAN VOLCKER. That second came awfully quickly! Are there any objections? I haven't heard any, so Mr. Corrigan is duly elected and the Secretary will so record. We have to approve the minutes.

MR. MARTIN. So moved.

VICE CHAIRMAN CORRIGAN. I second that.

CHAIRMAN VOLCKER. Without objection. Why are the reports on foreign currency and domestic open market operations separated [on the agenda]? We will go to foreign currency operations first, anyway. Are you prepared to report on domestic open market operations, Mr. Sternlight?

MR. STERNLIGHT. Yes I am. Sure.

CHAIRMAN VOLCKER. Well, we'll go to Mr. Cross first and you second.

MR. CROSS. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Any discussion?

MR. WALLICH. Sam, after listening to the conversations in Basle, would you get the impression that if sentiment on intervention is moving in any direction at all, it's moving in the direction of doing something more drastic--perhaps without the United States-- [say], accumulation of some resources from interest and hitting the market hard when the dollar is already declining?

MR. CROSS. Well, it's very difficult to say what they might do. I would think that the desire, obviously, is very much to have the United States: (a) take the lead; and (b) certainly, participate. Now, whether they will bring themselves to very large intervention in our absence--if we are out of the market entirely--looks pretty doubtful.

MR. BOEHNE. What kind of money are they talking about?

MR. CROSS. I don't know that anybody is talking about any specific amount of money. I think there is a problem in that the

operations that have been undertaken during this period--certainly on the United States side on the occasions that we have operated--have been limited to fairly modest amounts. On one occasion it was \$40 million and on another occasion \$48 million; the most we did was close to \$150 million. There certainly is a feeling that one needs to act both in greater amounts and also with a greater forcefulness, as it were. They understand the U.S. view about not wanting, as I said, to bash the currency; but they do feel that something needs to be done to deal with these exchange rates more forcefully than has been done. There was certainly some uncertainty in the market after the G-5 announcement about what it meant. As time has gone by, that has tended to fizzle out and there has been the feeling that the intervention, while not insignificant, really hasn't been of a forceful and large nature, given the magnitude of the problem.

CHAIRMAN VOLCKER. [Unintelligible] go about intervention in the least effective way--in fact, I would say a counterproductive way. You can follow up on--

MR. WALLICH. Well, if I may pursue this a minute. Didn't you get the impression--I did myself--that the German intervention of September [1984], which was massive and to us appeared very heavy handed and clumsy at the time, is regarded much more positively over there as having been a really successful operation? Maybe that's [why] they seem to think it's the way to go--to wait until the dollar is softening and then push it down.

MR. CROSS. Yes, I certainly think that. Absolutely. As a tactical move, the German operation of September did introduce a considerable amount of two-way risk and uncertainty in the market. It was very heavy and it is seen as having been a very useful and attractive operation. Now, in subsequent times when they have taken similar kinds of actions, they have not been as effective. But I don't disagree with you. I think it had a very powerful impact on the market; for some period of time it had the market wondering whether it was going to be hit again one of these days. That certainly introduced a certain caution in the market and I would think that that is a useful thing to do. There is certainly, on the part of some of the Europeans, a strong desire to see if tactics of that sort could not be used again with the same impact.

MR. PARTEE. But it inevitably runs out of steam, doesn't it? Where was the mark then? What was the mark/dollar rate when they did all that intervention?

MR. CROSS. Yes. It went up on the day that they hit it [hard]; at its height it was 3.17 and it went down about 4 percent.

MR. PARTEE. And where is it today?

MR. CROSS. It's at 3.29, but between September and February it went up. It certainly was an element that introduced a great deal of caution into the market and I think it did have a lasting effect for some period of time. On that day I believe they spent about \$400 million; we're not talking massive amounts in the billions that were spent. I think everybody is fully cognizant of the limitations of intervention; in fact, maybe too much so. No one expects it by itself to solve all the problems in Europe or here. But certainly there is a

view that, properly and forcefully used, it can be one additional weapon that can be very helpful in keeping this quite troublesome exchange market situation perhaps a little less volatile--I mean volatile in the upward sense.

VICE CHAIRMAN CORRIGAN. On the other side of the coin, though, Henry, if nothing happens to the exchange rate, I think it is pretty clear that there's likely to be more pressure on interest rates in a number of those countries.

MR. WALLICH. Yes, that's the point that several of them made.

MR. CROSS. I think all, or certainly a lot, of the Europeans are going to be under upward pressure on their interest rates if their exchange rates continue to depreciate.

MR. AXILROD. Governor Wallich, if I may add a [different] and maybe minority view on that operation: I would tend to deny its success. I think it was rather a hit and run operation and that the failure of the dollar to go up--if that's a failure--subsequently, had a lot to do with the drop in interest rates in this country through the winter. And I think the expectation that that [decline] was coming to a halt was instrumental in the dollar turning around. When it turned around and got to that point it just went right through it; it kept going, as there was no intervention of significant size and determination forthcoming at that time.

MR. WALLICH. I'm simply saying that we took a negative view of that operation; we viewed it as being contrary to good practice of not driving the rate but leaning against the wind. They seem to take a more positive view of it. And they seem to be of a mind to repeat it even though they know that they wouldn't get our cooperation on an operation like that.

MR. BOEHNE. Looking back over the last 4 weeks, if we are going to do something like this, what's the strategy of doing it the way we have done it? If we're going to do it, we ought to do it with some conviction or it's hardly worth the trouble at all. It seems that we're intervening as though we're kind of being forced to do it and we really don't want to. Our intervention doesn't strike me as being very convincing to anybody.

CHAIRMAN VOLCKER. Are you answering that question, Mr. Cross?

MR. CROSS. I don't think anyone will disagree with what you've said. I think you're right: that we need to act more forcefully if we're going to go in there, and show that we mean business and that we are prepared to do something in other than token amounts.

CHAIRMAN VOLCKER. There are several cooks in this broth and some are from rather provincial provinces.

MR. GUFFEY. Just to follow that up: As we talk about our intervention, how much control do we have over it at this point? Any

at all? Do we have any say, unilaterally, as to what the central bank will do?

MR. PARTEE. We [unintelligible] the central bank.

MR. GUFFEY. Okay. It may be that unless others change their minds we don't have any choice.

CHAIRMAN VOLCKER. Well, we don't operate unilaterally. Neither does the Treasury.

MR. PARTEE. Is this episode about over, Paul? As I recall, on the [FOMC telephone conference] call you said it was [to last] for a few weeks. A few weeks have gone by. Has it terminated?

CHAIRMAN VOLCKER. I don't think we're bound by that, particularly. Obviously, we haven't been acting effectively at all--

MR. PARTEE. Not at all, recently. That's why I asked the question.

CHAIRMAN VOLCKER. --in the burst of the last couple of days. But I wouldn't say minds couldn't change [if] this [dollar] movement gets pretty strong. But I think it had better get strong enough so that--. I personally am sick and tired of doing ineffectual things. I want to be effectual, or at least have a chance of being effectual.

MR. FORRESTAL. Sam, do you get the impression that the British are going to resist pretty forcefully allowing sterling to come into parity with the dollar?

MR. CROSS. Well, resist? We're almost there. They are concerned about the exchange rate. They have raised their interest rates by an enormous amount and they have a very soft economy. So in that sense, they really have moved very, very strongly. They have not done an enormous amount in intervention. They have done some, but--

CHAIRMAN VOLCKER. They have done very little intervention.

MR. CROSS. --very little.

CHAIRMAN VOLCKER. At one point they put their interest rates up 4 percentage points. Do you consider that a strong action in the space of about 3 days?

MR. FORRESTAL. But the question was: How much further are they prepared to go?

CHAIRMAN VOLCKER. Up another 4 points? They may not be prepared.

MR. PARTEE. How likely would it be that we would put ours down 4 points?

MR. CROSS. I think they feel that the 4-1/2 points that they have done is really quite a response to the downward exchange rate--

MR. WALLICH. Well, I think there is something to be said for what we've done so far. Yes, it would be better if we could operate effectively; but after a long time of doing virtually nothing we've now taken a few small, modest steps. It seems to me that that's something one could build on.

CHAIRMAN VOLCKER. I can see the essay now: "In Defense of Ineffectiveness."

MR. WALLICH. Well, before you become effective you have to be ineffective.

CHAIRMAN VOLCKER. I will accept that. You just gave the rationale for what we've been doing: We have to go through this period of ineffectiveness. Would you like to ratify these ineffective transactions?

SPEAKER(?). So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection. Mr. Sternlight.

MR. STERNLIGHT. [Statement--see Appendix.]

CHAIRMAN VOLCKER. How much of [the \$6 billion leeway authorized for the intermeeting period] did you use?

MR. STERNLIGHT. At the maximum, \$4.4 billion. It wound up at just \$4.3 billion, but we had so much uncertainty, particularly about what was going to happen to Continental's borrowing, that I think it was useful to have that flexibility during the period.

CHAIRMAN VOLCKER. Any comments?

MR. PARTEE. Do you mean on the [leeway] recommendation [or on his report]?

CHAIRMAN VOLCKER. Either one.

MR. PARTEE. Well, I wanted to ask a question of Peter. Perhaps everybody else in the room knows this, but I don't. Early on you were talking about how you were running compared with the nonborrowed reserve path and you said that at year-end you were \$300 million above it.

MR. STERNLIGHT. Right.

MR. PARTEE. But then later you came closer to the nonborrowed reserve path.

MR. STERNLIGHT. Yes.

MR. PARTEE. Now, does that mean that the path called for a 35% increase? We've had a very large increase in nonborrowed reserves. Or does it mean that you adjust that path week by week?

MR. STERNLIGHT. The path gets adjusted as we proceed.

MR. PARTEE. So, unless we know what the adjustments are, we don't really know what [unintelligible] an operation.

MR. STERNLIGHT. The guiding principle in drawing the path is to accommodate required reserves and the estimated demand for excess reserves and then the allowance for borrowings that comes out of the Committee's discussion. And if, as we proceed through a period, we find that required reserves are growing more substantially, we fold that information--when we get it--into a revision of the path. Most of those revisions--

MR. PARTEE. So, if you have strong monetary growth, you'll raise the path?

MR. STERNLIGHT. Yes.

MR. PARTEE. Okay. Thank you.

CHAIRMAN VOLCKER. Unless we increase borrowings.

MR. PARTEE. Well, I understood him to say that it will raise the path.

CHAIRMAN VOLCKER. [Unintelligible.]

MR. STERNLIGHT. That would have been an alternative and could come into the discussion also.

MR. PARTEE. Well, I just thought somebody might misinterpret it when you said you came so close to path. One needs to understand that you're constantly revising that for the larger growth [in required reserves], because otherwise one would think you were shooting for a very large rise in nonborrowed reserves.

MR. STERNLIGHT. Well, we're shooting to accommodate required reserves--

MR. PARTEE. Whatever is called for.

MR. STERNLIGHT. --at that level of borrowing.

MR. PARTEE. On the [leeway] recommendation: I have no problem with it.

CHAIRMAN VOLCKER. Any other comments?

MS. SEGER. I just have a question. Hearing your comments after hearing Sam's, I wondered: How much coordination is there between the two--[the foreign and the domestic operations]? I heard you talk about tilting, which would lead to a higher fed funds rate etc., and yet I heard [Sam talk] about the problems of the dollar and how when rates ticked up the--

MR. STERNLIGHT. Well, there's close coordination in the operational sense of Sam and his people being aware of what we're doing each day and vice versa. And on something like the drawing of the paths--whether we're talking about up to \$300 million with a bias on the accommodative side or later modifying that bias--that is all

coordinated through conversations with senior staff here and ensuing discussions that keep the Board informed. Certainly, we are keeping the Committee informed in our reports on the market: the morning call and the weekly reports.

MS. SEGER. I guess what I'm saying is: If, as you saw the fed funds rate tick up you also saw a rather immediate impact in the foreign exchange markets, if we're concerned about a super dollar and we're concerned about whether or not we're intervening enough, I just wondered if we ever close the loop or get any feedback in here?

MR. STERNLIGHT. Well, certainly we were aware of what was happening day-to-day on the dollar. And there were some individual days when the strength of the dollar had a fair input into the timing of our operations--the decision of just when to go in to put reserves into the domestic market.

MS. SEGER. But it never made you think that it might be inappropriate to allow the fed funds rate to continue to move upward?

MR. STERNLIGHT. No. I think that we did have some concern about what was happening when funds were getting up to 8-1/2 to 8-3/4 percent, and we [began] shaping our operations in a way that I think helped to bring it down to 8-1/4 percent, though I wouldn't say that that was specifically a target.

CHAIRMAN VOLCKER. This is not a complete answer, but the domestic operation is very inflexible. They operate--

MS. SEGER. I'm just trying to educate myself.

CHAIRMAN VOLCKER. It's a good question. But [in the domestic market, generally] we operate at 11:30 to 11:45 a.m. Once we have made that decision [after the morning call], it's over. It's a revolution if we operate at 2:30 in the afternoon because at that point if the market sees the funds rate going up, that raises questions about whether we're pegging the funds rate. So, it's a perfectly reasonable question. But the fact is that the opportunities --just on an operational basis--during the day to take account of [exchange market developments] are limited. If we miss it because maybe the market wasn't acting that way at 11:30 a.m., we've missed it. Now, maybe that's not the way we should operate, but that is the way we do operate.

MR. WALLICH. If we have a money supply target and at any one time in any one day we don't act--in order not to drive up the funds rate because of what that might do to the dollar--then that has to be made up some other day. Otherwise, we miss our target and it may then mean a larger funds rate increase than if we had done it right away. We can't tell in advance.

CHAIRMAN VOLCKER. We may also find out after the fact that it wasn't necessary to operate that day at all because the forecast has changed. That's not unusual; I suppose there's a 50-50 chance of that.

VICE CHAIRMAN CORRIGAN. If there were any systematic effort, as opposed to these issues of finesse, to place more direct

significance, say, to the exchange rate in terms of Peter's day-to-day operations, I think that's the Committee's decision, not Peter's--with all due respect to Peter. I think there is room for the finesse factor from time to time, and I think he uses it. But I interpret your question as being a little more fundamental than that. I think if it's a more fundamental question like that, that's a decision we have to make, not him.

MS. SEGER. Just hearing the one presentation following on the heels of the other made me connect the two.

CHAIRMAN VOLCKER. A very good question. Are there any other comments? If not, do we have a motion on this [intermeeting] limit?

SPEAKER(?). So moved.

MS. SEGER. Second.

CHAIRMAN VOLCKER. Without objection. We need to ratify these transactions.

MR. MARTIN. Move to ratify.

CHAIRMAN VOLCKER. No objection. Mr. Kichline.

MESSRS. KICHLINE, PRELL and TRUMAN. [Statements--see Appendix.]

CHAIRMAN VOLCKER. I'm puzzled here. In July we projected a real GNP increase, 4th quarter to 4th quarter, of 3 to 3-1/4 percent?

MR. KICHLINE. That is correct--for 1985.

CHAIRMAN VOLCKER. Oh, for 1985! Well, now is the time to comment on the business and price situation. Governor Wallich.

MR. WALLICH. You have a near doubling--well, maybe not quite a doubling--of unit labor costs but very little increase in [the rate of] inflation. Is that the effect of offsetting factors?

MR. PRELL. Governor Wallich, the unit labor cost increase last year was 2 percent and, as I said, goes to 3-1/4 percent and then to about 3-1/2 percent next year. A quick inspection of that chart indicates that there has been a very large gap between price increases and unit labor cost increases over the past couple of years. The increase in markup that has occurred is extraordinary in historical terms; and we're basically just seeing a narrowing of this gap in the period ahead. The unit labor cost [increases] will still be running a little lower than the price increases.

CHAIRMAN VOLCKER. Let me ask you a question following that question. In terms of these projections, we center on 4 percent for prices this year, which is an increase in the rate of price increase from last year. I get a little concerned about presenting price [projections] of an increasing rate of price increase--which show a great faith in Federal Reserve policy--particularly when it's not clear to me why that should be. You have this decline in the dollar in your projection--I'm not talking about your projection; basically,

I'm talking about other peoples' projections--but I don't know whether people assumed a decline in the dollar. Last time we used the convention that we would not; I think we assumed some general range of fluctuation within historical experience, which seems to me a reasonable convention. It turned out to be a lot better, because the dollar was up, than if we'd assumed a depreciation. The actual price results have been at the very lower edge of our projections. And I wonder why we're so pessimistic on prices this coming year when the wage trend looks good, the dollar continues to appreciate, the profit margins have widened, as was suggested already, and the unemployment rate doesn't go down much. One can argue about productivity; the staff doesn't have terribly buoyant productivity estimates and maybe everybody else is very low on productivity. But I would like to hear why [people think] prices are going to be worse this year than last year.

MR. PARTEE. Well, it's very little. I have a 4 percent projection and I guess I would say it's a much better projection than I had at midyear for this year. There's only so far you can go!

CHAIRMAN VOLCKER. Your philosophy is to catch up to reality slowly.

MR. PARTEE. Well, I also would be inclined to think that this rise in unit labor costs will have more effect on GDBP--pushing it up a little--than is shown in this chart. I don't think I would have allowed for that kind of compression in the difference between unit labor costs and GDBP and I did have in mind some kind of a decline in the dollar.

CHAIRMAN VOLCKER. Apart from the decline in the dollar, I presume over a long period of time unit labor costs go up the same as prices.

MR. KICHLIN. I think the relationship is quite closely connected. I would say also, in response to Governor Wallich, that our general view in looking at the price situation is that one would take some standard measure of productivity and, in a sense, assume a markup by corporations over some standard unit labor cost measure--so that the cyclical gains that you get early on are rather quickly translated into additional profits. But this rise that we see in unit labor costs we would not translate immediately into an attempt by corporations to add on to that; rather, they would be taking a longer-term view.

MR. WALLICH. At lower profits?

MR. KICHLIN. That's right.

CHAIRMAN VOLCKER. Not a lower profit. There's no [change] in margins.

MR. KICHLIN. Lower than if they priced higher. We had more inflation with the same unit labor cost. We also had more profit, but we have to stick that income somewhere.

VICE CHAIRMAN CORRIGAN. My own interpretation of the price forecasts, looking at the range of forecasts as well as my own, is

that I consider them basically unchanged. If you look at the deflator on a fixed-weight basis, excluding food and energy, for the four quarters ending in 1984 and the four quarters ending in 1985, it's basically 4 percent in both years. And when you look at 1985 as opposed to 1984, ending up with the same rate of inflation is better in some sense because, if the economy behaves like the forecast, I think we're going to have at least some pressures from commodity prices over the next year. The dollar certainly isn't going to continue to go up; it probably will go down. But even if it stays the same, people are not going to buy as much and we will get some further pressure on a year-over-year basis from unit labor costs. But I personally don't interpret the forecast as saying that inflation is worse in 1985 than in 1984. It is either about the same or maybe a little better.

CHAIRMAN VOLCKER. I'm going to have a heck of a time explaining to the Congress that a number that goes up is really essentially the same or a little lower!

MR. PARTEE. Tell them that it usually goes up quite a bit more in the third year of an expansion.

MR. BLACK. In the third year of an expansion that's really not much of an increase.

CHAIRMAN VOLCKER. I'm not sure as far as third years of expansions are concerned, but I don't see where we get any increase. I don't see why we don't have a decrease here, with what I see going on.

MR. MARTIN. I support the decrease-to-constant hypothesis, Mr. Chairman. We increased capacity by over 3 percent last year; there has been a surprising rehiring of experienced labor; and there is all of this talk that we heard earlier about the use of computers and telecommunications equipment and all that stuff that made up the investment boomlet. Surely, these organizations are going to do something with this equipment other than look at it and display it to visitors--which are two of the functions of this sort of new equipment. It seems to me that they will still have the pressure from foreign competition and that finally someday, somehow, sooner or later, the slimming down of many organizations that occurred--as the charm school middle managers were sent on their way and other adjustments were made in management and staff ranks--is going to have some effect on labor costs in a positive direction. My own personal projection was for less inflation--someone has to be an outlier--in 1985, and I would support your statement of a constant or declining [rate of inflation].

CHAIRMAN VOLCKER. I don't want to get the whole conversation going on this point. I think you might look at it again in the light of an unchanged dollar assumption. Not as much as a lot of other people, but we have been high on our inflation estimates before. I don't know what prices are going to be, but there certainly will be a range of uncertainty. Maybe they will go up. The question is where the greater probability lies.

MR. WALLICH. Could I ask a question on that? The greater probability is the number on a skewed distribution. Presumably, the

probability distribution of inflation is that it can't go much below zero but it can go up quite far; it has a long right hand tail. Are you thinking in terms of the mode--the most likely single value--or the mean, including the tail?

MR. KICHLINE. We have alleged for years that we have a modal forecast. I would say that it's very difficult, but basically, if we use the model and try to come out with confidence intervals, the model comes out with substantially lower rates of inflation. In fact, if you put a 70 percent confidence interval around our deflator estimate, a couple of times we drift out of that range on the high side. So with the same policy assumptions for 1985, the model forecast, for whatever it's worth, is a rate of increase in the deflator one percentage point less than in the staff forecast. I view that information as saying that the risks tend to be skewed on the down side. We think 3-1/2 percent is the most likely outcome; but if we're wrong, I'd say we're probably too high rather than too low.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLE. I have a couple of questions, Mr. Chairman. Two of the most difficult things to forecast, as you know, are what will happen with the Federal deficit and what will happen to the dollar. I was just wondering if you did any sensitivity analysis in terms of alternate forecasts, supposing that there's no depreciation of the dollar and supposing that there's no action to reduce the Federal deficit.

MR. KICHLINE. Ted, I don't know if we can run one with the exchange rate unchanged. You have some numbers on that there. We do run one that has a fiscal assumption of no fiscal action at all, so that would add \$50 billion dollars, essentially, to outlays: \$40 billion in outlays and \$10 billion of less taxes. In 1986, which is the relevant year because we assume these fiscal actions take effect in 1986 and beyond, we get something like 1-1/4 to 1-1/2 percent higher real GNP--in the neighborhood of 4 percent or a little higher. The deflator in 1986 is only up a tenth or two but the momentum builds as you get into 1987 and beyond. Short-term interest rates in that scenario are about a percentage point higher in 1986 than those in the staff forecast.

MR. TRUMAN. On the dollar, taking not the fourth-quarter level but the estimate for the first quarter--which is a good deal lower than we are now--as the jumping-off point, we don't get too much direct impact on either real GNP or prices from an unchanged dollar, since that [decline] is behind us. In the 3rd quarter, we get 0.2 down in each and then next year we would get a larger impact of twice that magnitude--an additional 0.4.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. I wanted to ask a question about the debt to disposable income ratio. Your chart shows that ratio moving up pretty rapidly; it's probably near or a bit above the 1979 high. Do we know what accounts for this run-up in debt? Is it due to demographic forces or what really accounts for it? And if that debt ratio stays at about the same level or goes up, do you think it's going to put a constraint on spending in 1985?

MR. PRELL. Well, we've been investing some special effort lately in trying to explain the behavior of debt. The major ingredient here is the consumer installment credit; its growth relative to income has been so sharp over the past couple of years. There are a number of factors that seem to be at work. One, as I mentioned, is that durable goods spending has been exceptionally strong, and that presumably is an area of spending that is relatively debt intensive. Another factor is a rather mechanical one: For a year or two after the period of credit controls, people seemed to be quite reluctant to use debt. [Credit] extensions during that period were depressed and it takes a while for the higher level of extensions subsequently to leave its full imprint on the repayment flows. Right now, and over the past couple of years, we've had a relatively low repayment flow from these past extensions, though we have a higher level of extensions currently. And as I indicated, in our projection we're expecting a catch-up as the more recent debt is what is mostly reflected in the repayment flow. There may be some demographic characteristics involved here. Clearly, over the postwar period as the population has aged, the younger generations have been more inclined to use debt. There's some evidence of that over time and there are a number of other minor factors. But this mechanical matter of extensions and repayments alone, according to some simulations we did, seems to explain a great deal of that debt growth. We don't have data anymore on extensions or repayments, but our inference would be that a fairly normal pattern of debt usage relative to the spending that has occurred would have produced this acceleration and should also produce a marked deceleration. As to whether it imposes a constraint, the logic would suggest that those individuals who have drawn upon their credit lines and so on and built up some debt may have some marginal constraint on their further spending. But this is a widely distributed debt. The evidence is that over the past several years it has been people in higher income brackets that have taken on most of this additional debt. They presumably have more flexibility and probably have more assets, so it should be only a limited constraint.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. Mr. Chairman, I wanted to take exception to the [projections for] housing starts and residential construction volume for 1985. As the chart showed, the mortgage commitment rate is hovering around 13 percent on a 30-year fixed-rate loan and the proportion of adjustable rate loans has dropped significantly. I don't believe, given the satisfaction of the deferred housing demand that has occurred to date, that we can reach 1.75 million [in housing starts] or \$166+ billion in residential investment in 1985. It could happen with a lower [mortgage] rate but the assumption of the staff is for somewhat higher rates, particularly toward the end of the year. In the models I've seen, it would take a fixed-rate somewhere around 12-1/2 percent. If you add the servicing on to that mortgage commitment rate for 30-year fixed-rate loans you get about 13-1/4 percent. So it seems to me that we're looking at 1.5 million rather than 1.75 million [on starts].

There are a number of other institutional changes. We know that the investigation of the Bank of America mortgage-backed security fraud situation is only beginning. There will be some investor reaction in the mortgage-backed security area. The thrift institution

regulators are attempting to slow the growth [of such securities], and to the extent that there is some degree of success, that would affect availability. And finally, there is the so-called willingness factor in home buying that is disappearing, in the sense that the appreciation motivation that has been so prominent over the last several decades is waning in several regions of the country. The motivation to buy is for shelter and not for appreciation. The syndicates have been pushed out of the market in the multifamily area; the multiple unit vacancy rate is terrifically high in some parts of the country. It isn't enough to do a macro job and get this very high vacancy shown on the chart. For the United States there isn't a national housing market; there is mosaic of sub-markets around the country; and many of those have very, very high vacancy rates. So I don't see how we can get 600,000 or 650,000 in multifamily starts in 1985. I suggest that the forecast is [.25 million] high. That doesn't exactly throw the forecast out.

I would couple that remark with a commendation for the analysis in the rest of the structural forecast for the next year in terms of real business fixed investment. I think it's a very good analysis, showing a very big cutback in structures in the real business fixed investment area. I did a little work prior to the meeting and then found that I was caught in the sense that I was only verifying what the staff has done here. I think that's quite accurate.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. On the business fixed investment chart I continue to be amazed by this very favorable red trend line that we've watched the last couple of years, which seems completely out of context with our experience. Mike, I think you did comment as you went through the charts that most of that line, or a significant part of it, is in the communications/computer area. My question is: If you were to separate out what I would call for lack of a better term the "grunt stuff"--the heavy capital production type of equipment--from the computer area and then, in turn, take a look at the part of that heavy equipment that is being supplied by the international market, wouldn't the line in fact be very, very different? And wouldn't that be a way of dramatizing how terribly uneven all of this is, despite the fact that we have a trend line that looks very favorable?

MR. PRELL. Well, I confess I have not done the calculation for the residual component of producers' durable goods. It's a very logical concept; I wish I had done it. This aggregate here includes office and store machinery, communication equipment, scientific engineering equipment, and photographic equipment. It is a pretty good piece--almost half--of producers' durable equipment. My sense is that if you looked at the rest of the numbers, you would see a much more moderate advance. But as things progressed last year, we did see some fairly substantial increases in the heavy machinery area and so on. There is the distinction between production and purchase of this equipment. Clearly, the share of equipment sales that is going to foreign producers has increased very considerably. So the implication for domestic firms and the capital goods industry is one that is not quite as rosy as this picture.

MR. KEEHN. Thank you.

CHAIRMAN VOLCKER. Didn't those figures you had the other day suggest something like 50 percent of the increase in equipment was imported this year?

MR. KEEHN. I think it is higher than that.

MR. TRUMAN. But the share this past year was about 25 percent.

CHAIRMAN VOLCKER. That's the share of the total?

MR. TRUMAN. Share of the total.

CHAIRMAN VOLCKER. You had a chart that had absolute numbers where one could see the increase in imports and the increase in the total.

MR. PRELL. Maybe I have those numbers. The figure we have for 1984 was: total purchases of business capital goods excluding motor vehicles rose \$18 billion, of which \$10 billion was foreign. And the overall penetration is about a quarter.

MR. PARTEE. Wouldn't help things too much around Chicago, Si.

MR. KEEHN. That's the problem.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. Are you ready for more general comments?

CHAIRMAN VOLCKER. I am.

VICE CHAIRMAN CORRIGAN. Let me make a couple of more general comments. Our own view of the economy for 1985 is one that has real GNP growing about 4 percent, with the deflator a shade lower than that. And at this juncture, that has the characteristics of a good forecast from my perspective. In the short run it could actually be a bit stronger. The impression I get from talking to business people and others over the past month or so is that most of them have been marking up their projection of real growth and marking down their inflation projection for the year. But I think there probably is a consensus somewhere in the 3-1/2 to 4 percent range for both real GNP and prices.

On the point that was just brought up, the feeling comes out very, very forcefully in comments from directors and business leaders that we have crossed the Rubicon on this external stuff and that it may already be taking a bigger bite than even those numbers suggest. For example, who represents a very, very large multinational firm heavy in capital goods, thinks that in recent quarters 100 percent of the increase in spending on equipment is coming from abroad. Just within the past week he made some comments to the effect that he had seen his order book affected in a very sizable way just in the past month because of the international trade situation. So, that continues to be a wild card and it's getting wilder by the minute. I have some of the same concerns that Pres had

about the housing sector. It should be a good year, but there are some things in there that I find troubling as well.

Extracting from the traditional sectoral questions of what the risks are to a forecast, it seems to me that there are two or three more generic risks that are particularly important in the current setting. One of those is: What happens if interest rates go up in any appreciable way? Let me just define appreciable as more than a percentage point in the short run. Obviously, that would be a very difficult situation. And then you ask yourself: What could produce that? If the budget deficit is not reduced, that could produce it; and if the dollar declines in any appreciable way, that could produce it even though the cushion for a dollar decline is somewhat larger now than it was before. That result could also come from the economy growing too fast because, from my perspective at least, the balance in our credit markets is so precarious, as indicated in one of Mike's charts, that it doesn't take much to push us into a situation in which the economy is growing too fast. Even though that might not reflect itself in price pressures, it could easily be reflected in interest rate pressures. Then, of course, there is always the possibility--perhaps remote at the moment--that the market could conclude that money growth in some broad sense is getting away from us. So, there is a whole collection of things, any one of which I think could produce pressures on interest rates. And I think it goes without saying that any appreciable pressures in that direction would throw any forecast to the wind.

Another thing that I am somewhat concerned about in terms of risks is the burden of all this debt we're accumulating. I'm not as sanguine as I thought you seemed to be, Mike, in terms of the cumulative effect of that debt burden--particularly in the context of what I think is still some fragility in the financial system. And I don't think all of these crazy new markets and instruments that are coming along almost daily are helping that situation. Just to put that debt situation in one perspective: Since 1982, the ratio of nonfinancial debt to nominal GNP has risen by 17 [hundredths]. It's almost a vertical line, and the level of that debt right now is so far out of line with anything we've ever experienced. That's just another way of looking at it that is troubling.

The last thing I would mention on the risk side is the oil price; that has been talked about a little. I was surprised the other day when a point was made to me in a conversation with someone I regard as a fairly credible source. The nature of the comment was that among a group of people thought to be experts, a third of them now thought there was at least some possibility that the oil price could fall, say, to the \$16 range. No one was predicting that as a hard prediction, but there was at least the recognition of that as a possibility by a fairly knowledgeable and sizable group of so-called experts. I must say when I stop and try to think about the implications of that, I'm not sure what they are. They probably, or most certainly, are not good. So, in general, I come out with [the view that] everybody is feeling good about the situation right now but getting a little more worried about what the situation implies down the road.

CHAIRMAN VOLCKER. --more worried as you talked! Governor Gramley.

MR. GRAMLEY. Well, I think the forecast in many respects is a remarkably good one for the third year of a recovery--when growth in the first two years was well above the average for the first two years of recovery and in the third year the expansion is sustained at a rate well above potential growth and unemployment is reduced while keeping a low inflation rate and relatively stable interest rates. As I recall--and I didn't look this up--this forecast for '85 is not dramatically different than what the staff presented for '85 a year ago and I swore then that it couldn't happen. But we're here now and, if you look at outside forecasts, a very large number of them are centering on performance very much like this one. Indeed, when I put in my forecast, I found myself putting in numbers very much like what the staff has here.

In thinking about uncertainties, what worries me the most is what's going to happen to the dollar. Lots of people worry about that, too. Oddly enough, some people say if the dollar goes up, that will be bad for the economy and when you ask them what will happen if the dollar goes down, they say that will be bad for the economy, too. There are some bad things and some good things, but we need to keep straight exactly what is going to happen if either of those two outcomes occurs. I worry more--a lot more--about what's going to happen when and if the dollar begins to fall than if it rises further. If it rises further, it will put some additional restraint on the growth of domestic production but it will have beneficial effects on the inflation rate and beneficial effects on interest rates. And I think it is not too difficult to handle the negative aspects on domestic growth by adjustments of monetary policy, even though I am worried about the kind of protectionist measures that develop [in those circumstances]. If the dollar begins to go down and go down rapidly, particularly [unintelligible] as we're approaching the natural rate of unemployment, it's going to stimulate the economy strongly. It's going to put strong upward pressures on prices and, through both of those things, strong upward pressures on interest rates. And that we're going to have a lot of problems with. So, I hope the staff is right and we begin to get a modest gradual decline of the dollar beginning fairly soon.

CHAIRMAN VOLCKER. Sounds like one of the least likely forecasts--not that anybody has any better one.

MR. KEEHN. Just to comment generally on the outlook, the staff forecast is really quite consistent with ours. Our GNP is a little lower and our inflation is a little higher but not materially enough to comment on. But, as you can gather by my earlier comments, I am still just staggered by the continuing unevenness of it all. Many of the industries on the capital goods side are very weak and I think a lot of them have come to the conclusion that they are going to be left out and that this recovery is going to completely pass them by. I was talking with a man who runs a very large diversified company, including an extensive foundry operation, and they have concluded that they had better get ready for the next recession and now are in the process of closing permanently about half of their foundries. They just feel that that business is never going to come back.

A risk I would point out--and I would say it's a local risk, certainly not a macro or a broad risk--is this agricultural situation.

I almost don't dare mention it because I'm sure I can't say anything new or surprising and you've heard a lot about it. But it is very serious and is continuing to deteriorate. And it is one that I find very hard to get a handle on; I find it difficult to measure just how difficult and serious the problem is other than I have a hunch that the statistics we look at really don't adequately describe the problem. The land surveys that we look at suggest that land values are down 30 to 40 percent from the peak. But there isn't much land selling; and when land does sell, it's selling at 50 to 60 percent under the peak. People purposely are trying to hold land off the market [because] the real values are substantially lower.

As the land value goes down, the debt [unintelligible] will get very, very high at the agricultural banks. Cash flow just isn't going to be adequate to service the debt. The concern among the ag banks is getting very high. I went to the Iowa bankers meeting in Sioux City last weekend and I was pleased to get out of town in one piece! They are pretty close-mouthed about the problem but they all can see that the losses are going to be very substantial when they total the direct loans to the farmers and the indirect loans to suppliers and merchants and the like. Also in the Midwest there has been a lot of this trading of banks around that is supported by loans on bank stock, and I have a hunch that that will be a problem that's going to grow in magnitude. When you add those together, I think the losses on the portfolios are going to be very substantial. Another way of saying that the numbers hide the nature of the problem a little is this: Of the 530 state banks in Iowa only 15 have capital of 7 percent or less; and of those 15, 12 are between 6 and 7 percent, which would suggest that there isn't a problem from a capital point of view. But when asset quality problems arise, a bank can go through capital awfully darn fast and all of a sudden there is an escalating problem. The Superintendent of Banks in Iowa suggests that about 140 of their 530 banks are what he would call problem banks and by that he means that 60 percent of capital is classified. But he thinks that number is going to go up and that by the end of the year about half of their banks will be in the problem category. These are all, I think, small banks and this is somewhat of a regional problem as opposed to one with broad national implications. But I do suggest to you that this agricultural problem--and, again, it can't be news to you--is serious and is escalating and that the number of bank failures is going to be significantly higher in the Midwest this year than was the case last year. It is not at a level nor of the type of institution that could be destabilizing, but I think it is a risk that merits notice.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I've been in maybe a dozen meetings over the past month and I think this is the gloomiest couple of hours I've spent! Actually, the forecast looks like a pretty good forecast for the third year of a recovery and it seems to me that it's a reasonable forecast. I think you can argue with it in pieces but, at least in my part of the country, I find the mood more upbeat than I sense around the table. There is a long list of things that could go wrong; each one of them, certainly, could go wrong and 1985 could end up being a disastrous year. But it seems to me, if you're a betting person, that the outlook is really pretty good; and I don't see anything wrong with accepting a pretty good outlook when it comes our way. Clearly, there

are risks with the dollar and there are problems with agriculture and there are other areas of risk. But on the whole I think maybe the Federal Reserve ought to surprise the country and not feel too bad about the outlook in 1985. So, I would be inclined to take the forecast more or less as it is, acknowledge that things could go wrong, but still present an upbeat kind of outlook.

CHAIRMAN VOLCKER. Miss Seger.

MS. SEGER. First, in terms of the inflation outlook, I came up with 3-1/2 percent without taking into account the value of the dollar; then Ted Truman convinced me that the dollar is going to depreciate so eventually I rounded my number up to 4 percent. If I had assumed it was going in the other direction, I would have rounded it down to 3 percent because I just do these in whole numbers; I don't have the confidence that I can do it any more finely than that. In terms of productivity--and this is something that I'm very interested in--one factor I think we're soft peddling, if not ignoring, in this whole productivity discussion is simply the commitment of business managers to be more productive. I deal with some of the same kinds of people that Si Keehn does out in the Rust Belt and they are viewing this as a very high priority item. It's shape up or you're going to be dead; it's as simple as that. Therefore, this has given them a strong incentive to be more productive. I understand that, unfortunately, that doesn't fit very well into the econometric models, but that doesn't mean it isn't a factor and that doesn't mean it isn't a very important factor. Furthermore, I think this notion ties in with what we're seeing in plant and equipment spending: that in order to get the kinds of productivity gains they feel they have to have to compete with the imports, they have to bring in state-of-the-art equipment. I just saw a plant on Friday that had robots all over the place at \$90,000 per unit. It's not a small investment but they have to do this to improve their productivity. I think we're going to see more and more of this even in offices; maybe not in Washington, but in other parts of the country they are having to be more productive. They are having to use word processors; they are having to stretch clerical help by giving them better tools. I think we have to pay more attention to this because, as Jim said, it is important with respect to inflation possibilities and also to our growth potential.

Finally, [I am concerned about] the continuing strong dollar, the agricultural problem that Si has already referred to, the third world debt situation--I went to a meeting last week at the State Department about the latter and that doesn't seem to me to be a problem that has gone away--and the thrifts, which are still hanging on the edge of the cliff. Looking at all four of those factors, I find it very difficult to think in terms of interest rates going any higher at all, because I think that would push all of those problems into a still more serious mode. And heaven knows they are bad enough!

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, I agree with Ed Boehne only more so. I think the staff is projecting a smaller real growth for 1985 than we're going to realize. I put in a 4 percent number and I think that's a minimum; I really think we'll probably do better than that on real growth. It's hard for me to document my position very well on the basis of the numbers that have come in since our last meeting

because they are a fairly mixed bag. But one thing that has impressed me in the past few weeks has been the extraordinary strength in the stock market. Since the 9th of January the stock market has put on a display of business confidence of a sort that is quite rare in our history. I think that we're going to be revising up these real growth projections and by midyear, say, I think that is going to put us in a very difficult position with respect to the effects of our actions on interest rates. So, it seems to me that our problems in 1985 are going to be the problems of a very strong economy and they are going to be just as difficult to deal with, and perhaps more so, than the problems we would face if the economy came in weaker.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Mr. Chairman, we're in fairly close agreement with the staff forecast for 1985 but with a couple of different assumptions. One is that we [keyed] off the midpoint of the M1 [objective] and projected 5-1/2 percent M1 growth rather than the 6-1/2 percent that the staff has, and still came up with essentially the same numbers with the exception of the deflator; we would be somewhere in the range of about 1/2 percent higher on the deflator. The higher deflator number fell out of the unit labor cost component of the forecast, suggesting that unit labor costs would go up more than the staff has forecast. But in all respects, it would seem to me that we're going to get somewhat greater growth than the staff is forecasting in the first half of the year and somewhat less in the second half, largely because of the interest rate pressures that will be brought to bear because of that greater growth [in the first half] and maybe some action by the Federal Reserve to move against that.

I would also want to note for the Committee, as a follow-up on a comment of Si Keehn, that the condition of the agricultural sector in the high plains of the Midwest is a very serious problem. It may not have the national impact, much as he has suggested, but that does not mean that there will not be great social and other disruptions in that area. And indeed, it could get out of hand. I would also want to note quickly, having talked to the Farm Credit people, bankers, large input suppliers to the agricultural sector, as well as to some Congressmen, that I fairly well concluded that there is not a great deal that monetary policy can do to alleviate that problem, at least in the very near term--I'm talking about 1985 and quite likely 1986. I'm not sure that there is a role for this Committee with respect to taking action to try to alleviate the problem that rests in the agricultural sector.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, I'm inclined to join those who are probably a little more optimistic than the Board staff, although I think the staff's forecast is very reasonable and I would be willing to accept it. As for concern about all of the problems, I feel much as you did, Ed: I felt very good until I got here. Those problems are all there and they are all very real possibilities. I guess the worst of all worlds would be if every one of them really came to pass; maybe just one of them will. We will just have to wait and see what's going to happen on the deficit problem. The dollar problem is pretty much of an unknown, and depending on how that develops--or if some of these things happen--I think we would all be shifting our views entirely.

On agriculture, I tend to agree with Roger: I really don't know what we, sitting around this table, can do there.

In the discussion, someone mentioned the oil price going to \$16 or \$15 dollars a barrel. Several months ago, in discussing what the effect would be on our financial institutions if we got a pretty good drop in the price of oil, the feeling was that if the price got to \$25 a barrel, that was going to cause some very serious problems. Now that that is a very real situation, they are saying: "Well, when it gets to \$20 we're going to have some real problems." So, it's hard to judge just where that level is. I don't believe it's quite as difficult at \$25 now as they thought it was going to be--not that it's easy; it isn't. And now they are thinking maybe \$20 is where the difficulty is--

CHAIRMAN VOLCKER. Is the price \$25 now?

MR. BOYKIN. No. But I think it's becoming more and more of a reality that it's going to get there. Therefore, in the conversations, the assumption is that it's likely to get there so they question where the next down point is. But no, it's not there yet. Overall, looking at the situation today, I would certainly go forward with a great big smile on my face and keep my fingers crossed as I kept going.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, I didn't comment on the general situation earlier so let me briefly do that now, if I may. First of all, I agree with the staff forecast; we came out very, very close to it. The only minor difference I would note is that, like some others, the shape of 1985 looks a little different to us than to the staff: we think there will be greater growth in the first half than in the second. But generally speaking, it is a reasonable forecast and it's one that I would be prepared to accept and one that I would be prepared to base policy on.

In talking to people around my District, I sense that the confidence level is very high; there is a good deal of optimism about the economy. The private forecasters seem to be coming out pretty much the same way on growth and inflation. I, too, came to the meeting feeling pretty good; but unlike a few of my colleagues, I'm not particularly disturbed at what I'm hearing because I think that these problems are real. They are potential problems that I think we have to keep very clearly in mind--not that they're necessarily all going to happen, but I think we would [ignore] those problems at our peril. I think they are very real. I am beginning to feel in talking to some people that there is a sense of euphoria beginning to develop. And, at least in my small sample, people aren't even talking as much about the deficit anymore. They have had in 1984 a very, very good year of phenomenal growth; they are looking at good growth in 1985; and these the problems of the dollar, the deficit, oil prices, and agriculture seem to be diminishing in people's minds. So, I think we have to be careful to keep those problems very much in mind.

The only other comment I would make is that I'm not so sure this agricultural situation is really a parochial one and not a macro one. We have it in our District, so now we're talking about the

Midwest and the Southeast and perhaps the Southwest. And while the banks that might be affected are small, the aggregate of dislocation among the agricultural banks could be substantial. Again, while I'm optimistic, I think there are some dangers that we have to keep our eye on; but generally I would agree with the staff forecast.

CHAIRMAN VOLCKER. Except in prices, where you're much higher according to the--

MR. FORRESTAL. We were higher? I thought we had 4.2 percent for the GNP deflator.

CHAIRMAN VOLCKER. 4.2 percent, that's it.

MR. FORRESTAL. We had 3.6 percent for '85 over '84.

CHAIRMAN VOLCKER. 3.6 percent in prices?

MR. FORRESTAL. That's what I have.

CHAIRMAN VOLCKER. That's not what I have on this sheet, but I'll take it.

MR. FORRESTAL. Let me read my margin--

CHAIRMAN VOLCKER. Don't read any further; 3.6 percent, you said?

MR. FORRESTAL. Well, 4.2 percent is the deflator number I had [unintelligible]; I thought I had the 3.6 number in front of me. Is that correct?

CHAIRMAN VOLCKER. We'll take it.

MR. FORRESTAL. 4.2 percent, and year-over-year 3.6 percent. I had it right.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I think the staff's projection is certainly plausible and we can't quarrel much with it. I believe, like Frank Morris and Ed Boehne and Bob Boykin, that the risk is that the economy will come in somewhat stronger than that. Underlying their forecast is the assumption that the income velocity of M1 is going to grow a little more than 1 percent. That may well be right, but to me that seems on the low side of what is likely to happen. I would think it is more likely that we'll have more growth in nominal GNP as a result of a faster rising velocity, and I think that would be distributed partly between real output and prices. So, we come out at 4.4 percent on those. So far as the unemployment rate is concerned, I wouldn't be surprised to see that drop a bit lower than what we projected originally or what the staff is projecting. I think the demographics of the situation and improving real family incomes might well limit the increase in what the staff is projecting for labor force participation rates and bring that down maybe a couple of tenths of a percentage point below what they have.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, I'm inclined to agree with the optimists too. I think the short-term outlook is pretty good and the staff forecast is probably on the low end of what might occur in the next year. It has been shown pretty clearly now that what we had in the fall was a temporary stoppage in the growth and that growth has now resumed at a pretty good rate. I have this view that the outlook is good but the underlying situation is terrible. And the question is: Do we live in the short run or do we live in the long run when the underlying situation may reveal itself? I suppose the greatest problem that might occur would be a substantial increase in interest rates.

MR. MORRIS. I think what you really mean to say is that the real world is fine but the financial world is terrible.

MR. PARTEE. Well, maybe that's what I'm affected by. I agree with Jerry that a sizable rise in interest rates would be quite difficult for these burdened sectors to take on. I don't agree with him that a 100 basis points is a sizable rise. After all, rates are down several hundred points over the last several months, but I guess I would agree that a 200 basis point increase would be a very difficult thing. From my vantage point right now, I'm beginning to think our greatest problem may be an excessive increase in activity here that in fact will bring a 200 basis point increase in interest rates looking out 6 months from now. Therefore, I'm more on the side of those who are now becoming somewhat fearful of too much of a rise in activity rather than on the side of those who think it's going to be too small in the period to come. In the end all these problems and more that have been listed by Jim and others are going to come out in some way or other, but I think probably not in 1985.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. I think as one looks at the evolution of our projections, it has been very favorable. Growth projections have been upgraded and inflation projections have been reduced. I'm a little uneasy about the inflation projections but there are reasons for them. When you take the absolute levels, the rate of growth is very close to what we might consider potential and the rate of inflation is still way above what it ought to be. The staff has it coming down in a pretty satisfactory way; I doubt that [will happen]. In any event, I think there is much more to be done on that score.

CHAIRMAN VOLCKER. In the interest of accuracy, the staff has it about the same as it was last year.

MR. WALLICH. Oh! Hasn't it been coming down in recent projections?

CHAIRMAN VOLCKER. Their projections probably have been reduced.

MR. WALLICH. That's what I had in mind. Well, I have one other comment. We're in the third year of an expansion and there is no reason why expansions should come to an end after 3 years. But neither do I believe what the [Administration's] economic report says: that there is no relationship between the age of an expansion and the chances of it coming to an end. So I think the risks, as others have

pointed out, are that something untoward may happen and may interfere with this reasonably good evolution. We have no serious imbalances other than, of course, the terrible one--the budget deficit. But we have a number of danger points, mainly financial. So, again, there are potential sources of the evolution being disturbed. To me this suggests that the risks are more on the side of excessive expansion than of going down unexpectedly, and our policy ought to be [formulated] accordingly.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. I think the staff forecast is a reasonable one. I am impressed with the year-end business statistics, and for that reason I agree with those around the table who are optimists and who feel the odds favor a stronger recovery than the one that's built into the forecast.

CHAIRMAN VOLCKER. What are those year-end figures?

MS. HORN. Well, we could start with the 4th quarter GNP numbers and the auto numbers coming in strong. One of the things I was worried about at year-end was the buildup in inventories; I think that is not so severe, based on the variety of numbers that I see.

CHAIRMAN VOLCKER. On the other hand, I raised the question because new orders are down and housing is going no place on the latest numbers, and there are real questions about the commercial construction area. Who knows? The auto figure looked good, as did the inventory reduction.

MS. HORN. The whole personal consumption expenditures, or the consumer side, [looked good] and I tend to focus on that. In any case, looking at some of the assumptions that underlie my forecast--and I think a lot of the others around the table--one could build a case for consumer and business outlays becoming stronger. If you assume an expansive fiscal policy, no sharp changes in the exchange rates, no abrupt rise in interest rates, low farm prices, even lower oil prices, and so forth, I think you can build a case for a stronger recovery than the one that the staff is forecasting, and I think that's pretty close to my forecast. If the recovery is stronger, then the question about inflation comes up. I would see it not spilling into the '85 numbers but be a danger in '86. And that, of course, requires either fiscal or monetary policy, or both, to deal with it.

In the Fourth District, the pattern of business activity is sluggish with no particularly clear direction. But I can even put an optimistic light on the Fourth District outlook in that there is really a distinct change in mood, though it's probably short of Bob's term "euphoria." The impressionistic evidence we're getting has really quite a different tone to it. Of course, a lot of what we hear comes from the strong auto numbers in both December and January, but we're getting a lot of other stories. We've had no disappointment in retail sales in January, for example. We've had unexpected strength in chemical orders and, to a lesser degree, in both heavy trucks and steel orders as well. This is all recent and impressionistic rather than in the numbers. To keep from having a wholly optimistic report to the Committee, though, I will say that the talk about protectionism

has increased--if that's possible--in the Midwest. You can't get two business people in the Midwest together without that being the subject, and I think that's a terribly serious danger as we go forward.

CHAIRMAN VOLCKER. When do the retail sales figures come out for January?

MR. KICHLINE. 8:30 a.m. tomorrow.

CHAIRMAN VOLCKER. You could make a bold comment about them. Mr. Balles.

MR. BALLEs. Well, I want to make a comment on the general outlook. We're essentially in agreement with the staff forecast. In fact, our numbers are very close except that we're a little lower on inflation. We have 3.7 percent, mainly because we only expect a 4 percent decline in the dollar rather than 8 percent, but we would only be half as wrong. I think the staff forecast is quite plausible and I have no quarrel with it. I do want to say, though, that I think Chuck Partee put his finger right on it: The aggregate statistics look great but an awful lot of the economy looks sour. I don't ever recall a period in which there was such imbalance in the economy as we're witnessing right now. We really have two economies going here; it depends on what business you're in. None of our directors buys and sells GNP; they buy and sell other things. And if they are in the defense business, or aerospace, or electronics, or in some capital goods industries, they are doing great. But if they are in mining, agriculture, forest products, and so forth, they're doing lousy. To add to what Bob Forrestal and somebody else mentioned--that the Midwest is not the only place where agriculture is in trouble--two of our biggest banks are having problems right now and are under surveillance, in large part because of bum agricultural loans. Just so you don't get the wrong idea on that, it's not only bum real estate loans. There are bum farm loans and big chunks of very bad real estate loans; even the agri-business [unintelligible]. At big banks in California agriculture is a problem. I agree with Bob that it is not a local problem.

It's time to be optimistic as we look at the aggregate statistics and I feel optimistic in that sense. But only at our peril, I think, should we ignore some of these other factors, which sooner or later are going to come home to roost. Going back to Henry's remarks about there being no relation between the age and the health of an expansion, I would simply add that most expansions in my recollection have come about because of a combination of inflationary pressures and rising interest rates. And those are the things that right now certainly could trigger what looks to be a sound expansionary trend and [turn out to] be unsustainable developments that could quickly come to an end. I feel good about the general prospects for 1985 and I'm beginning to wonder how much longer we'll live with these big problems hanging over us. One or more of those problems could push us over the cliff before 1985 is over, but I don't think that will happen. That's more likely to occur in 1986.

MR. GAINOR. We've come down on the optimistic side of the staff forecast: a little higher on GNP and a little lower on the deflator. But those who have talked about the agricultural sector are

certainly reflecting our views. There are serious debt problems; collateral value is falling; and it has become a fairly hot political issue in our District and elsewhere, as you can imagine. There are bills in every one of our [state] legislatures to try to provide some relief for the agricultural sector. Most deal with ways to moderate the impact of debt service for the farmers. And, of course, one of the objectives is to provide some liquidity for spring planting--cash for seed--which is a very serious issue. While we don't think it is monetary policy's role to deal with this, monetary policy is not going to be immune in that there is a great deal of sensitivity to interest rates. And if rates start to rise, I think perhaps some political pressure that currently is not on the Fed will gravitate toward us. So we are concerned about rates in that context.

CHAIRMAN VOLCKER. If nobody else has anything to say, maybe we ought to have Mr. Axilrod say something about these targets for next year.

MR. AXILROD. [Statement--see Appendix.]

CHAIRMAN VOLCKER. We went over the question of whether to rebase last month. You're aware that that is one of the Administration's helpful proposals in its economic report and elsewhere. I detected very little or no--I don't remember [any]--sentiment for rebasing last time. You've had another month or more to think about it. Maybe we can dispose of that issue quickly, if you haven't changed your opinion. And if you have, let me know.

MR. MARTIN. I think the Chairman's memory serves him well. I don't believe there was any overt support for rebasing. To start from some theoretical level being captured by a range we set some time back has very little to recommend it, it seems to me. I would oppose any rebasing now, with all due respect to Bill Poole and his good language in the CEA report.

MR. MORRIS. Also, Mr. Chairman, with the revised numbers that we soon will be putting out, the deviation from the midpoint is down to three-tenths of 1 percent.

CHAIRMAN VOLCKER. No, no.

MR. BOEHNE. No, it's more than that.

MS. HORN. It's eight-tenths--5.2 percent.

CHAIRMAN VOLCKER. No, this change in--

MR. MORRIS(?). [The midpoint] was 5-1/2 percent, wasn't it?

SPEAKER(?). 6 percent.

MR. MORRIS(?). The range was 4 to 8 percent, that's right.

MR. BOEHNE. Aside from the numbers, I think Pres has made the basic case and I would agree with him 100 percent on this issue.

MR. BLACK. Mr. Chairman, I always have had problems with telling someone we're aiming for a percentage rate of growth from some

point we haven't reached, but I always have had sympathy for these moving lines around the midpoint rather than the moving megaphone.

CHAIRMAN VOLCKER. Well, let me get to that as--

MR. BLACK. Well, that's part of the--

CHAIRMAN VOLCKER. I'm going to get to that issue too.

MR. BLACK. Okay.

CHAIRMAN VOLCKER. They're somewhat related, but let me see what--

MR. PARTEE. I'd be opposed to rebasing.

MR. BLACK. I am, too, as you currently define it.

CHAIRMAN VOLCKER. I don't hear any sentiment for rebasing here.

MS. SEGER. May I just ask a question? I haven't seen what it would do to the numbers to have an average of the months for the preceding year used as the base. I think that was one of the proposals that--

MR. AXILROD. No, I thought they based it on the fourth-quarter average.

MS. SEGER. I think they have it two ways.

CHAIRMAN VOLCKER. I think they used the fourth-quarter average. But another question, which I have looked at myself at times in the past, is why we put all this emphasis on the fourth quarter instead of on a yearly average target. That's another way to do it.

MR. AXILROD. Well, the growth for 1984 year-over-year was 6.9 percent; fourth-quarter-to-fourth-quarter it was 5.2 percent, rounded. I could get you the level, but these things just tend to offset each other; as you go back over the years they tend to average out.

CHAIRMAN VOLCKER. Mr. Balles, did you have some comment on this point?

MR. BALLEs. Well, mine is the same as Bob Black's. I think a good alternative to rebasing, which has its problems, is the flexibility [unintelligible] the parallel line idea that we've seen in the Bluebook.

CHAIRMAN VOLCKER. Well, let me get to that in a minute. I take it there is no sentiment to rebase. In fact, I don't think that this is an intellectually stupid way to approach it. It's a perfectly reasonable thing to do, but I don't think there's any more reason to rebase than not to rebase. It depends upon whether, on the basis of the year's events, we're happier to start out one way rather than the other way, depending upon some kind of an analysis. And that's the way I would explain it. But the convention is not to rebase, so the

burden of proof is on changing it. In this particular year, if we rebased M1 up I don't know what we'd do about M3. We'd have to rebase it way down and have a peculiar explanation. The same is true for credit, I suppose, if we took that seriously.

MR. BALLEES. I did have one comment, Mr. Chairman. You said you'd get around to the idea of the parallel lines rather than the cone.

CHAIRMAN VOLCKER. I'm getting around to it right now. If I view the consensus accurately on the cones [it is not to] rebase.

MR. BALLEES. But my point is that if we don't rebase, we should do something else or I think we'll have a big problem with M1 appearing to be over its range for a good part of--

CHAIRMAN VOLCKER. Well, on this issue of how we draw the picture I will declare my position: I have never liked cones. I went on a little campaign a couple of years ago when the staff had palsy in that they couldn't write these things without making a cone. But, one part of the substance, anyway--in fairness, I don't think it's all that the Council [of Economic Advisers] had in mind--is whether we are disturbed that we are above the cone now. Now, this gets into the short-run policy decision a little as well as the longer-run. But I think--

MR. PARTEE. Growth has been pretty fast, if that's what you're asking.

CHAIRMAN VOLCKER. Well, I'm not quite asking that. I'm asking: Are you so unhappy that it's not so slow, having started in December above that cone as part of the low base, that you thought it was important to get it back in the cone in January or February? Now, I would just assert "no." But that's certainly an interpretation; I don't know what the Committee thinks.

MR. BALLEES. Well, Mr. Chairman, I for one would agree with you; I'm not worried. I would be worried, except for the expectation of the Board's staff--with which our staff agrees--that the velocity of M1 will probably be down in this current quarter and maybe for the first half of the year, and that it will be up in the neighborhood of 1 percent for the year as a whole. That's an excellent reason to run above path right now and maybe for a good part of the year. It is going to make us look a little silly every Friday in that chart showing the level of M1 in relation to the cone for the year that The Wall Street Journal prints. The same thing is in the San Francisco Examiner and heaven knows where else around the country. Those who don't look at it carefully or don't remember all of your fine testimony, say: "Aha! The Fed is off the money [target] and is overshooting again."

CHAIRMAN VOLCKER. Technically, it is literally true that the way The Wall Street Journal depicts the picture, they can write that for the week of December 31st we were below the midpoint of the money supply target and that for the week of January 7th--without any change in the money supply--we were above target. I don't think that makes a lot of sense, but--

MR. PARTEE. Paul, when we use the parallel line, I think we ought to be clear what the meaning is. If we are well above where the cone would be in the early part of it but below the top parallel line, I believe that means that the growth rate from there on until the end of the area covered by the parallel line has to be less than the midpoint of the cone. Isn't that right?

MR. BOEHNE. Right.

MR. PARTEE. So, it's really just cosmetic. It means that we have to get a lower growth rate if we're above that.

CHAIRMAN VOLCKER. This is literally drawing pictures, but pictures affect things. I don't know how we want to draw this. One way that appeals to me, but it's a really special case because I think it's more substantive--. If we just draw parallel lines, we have to ask ourselves the question: Would we be particularly happy--right now starting off in the upper part of the parallel lines--to go down to the bottom part, which is way below the cone?

MR. PARTEE. That's a precipitous drop.

CHAIRMAN VOLCKER. It would be quite a precipitous drop. And I would argue--I think as a matter of substance, recognizing that all pictures aren't perfect--that we could just draw parallel lines and say this is the way it looks with parallel lines. We could draw parallel lines and a cone. That's one way of handling this; we've done that once. We also drew a skewed one once. I think it has some meaning to say that we have the points in the fourth quarter of this year, which are established by the basic target, whatever that is. We started out above the cone because it was coming up, largely in January but in December too. We probably don't contemplate--or wouldn't be really happy based upon anything we know now--going below that lower line in the cone. And we could draw a line up from that point in the fourth quarter back to the upper part of the range in the fourth quarter of this year. The result would be a truncated cone; I think that would be the mathematical expression. And it would be, I think, a substantive portrayal of the area in which we might like to be. But it's just one way of drawing the picture.

MR. GUFFEY. Would you describe that again?

MR. PARTEE. Just fill in the top of those lines?

MR. GRAMLEY. It looks a bit like a whale, I think.

CHAIRMAN VOLCKER. Draw a line from the fourth-quarter target of this year to the fourth-quarter target of next year. That's a line.

MR. PARTEE. Oh, I see.

MR. GUFFEY. And then draw a cone off of the fourth-quarter average? Would that be the point?

MR. PARTEE. [Unintelligible] look at it in these terms.

CHAIRMAN VOLCKER. If you do it that way, the bottom lines are the same as the cone. Well, look at M2 here. It does not look very different from that; that top dotted line there would be a little higher.

MR. PARTEE. It would be a little higher at the beginning.

CHAIRMAN VOLCKER. At the beginning, yes.

MR. GUFFEY. Isn't that essentially rebasing?

CHAIRMAN VOLCKER. You're ending up in the fourth quarter just where you would end up anyway.

MR. PARTEE. Yes.

MR. BOEHNE. You would start the top parallel line where the 8 percent is? Is that how you would do it?

CHAIRMAN VOLCKER. Well, not at the end of the year. I would start it in November.

MR. BOEHNE. All right, at the end of November. And you're going to call this a truncated cone?

CHAIRMAN VOLCKER. I'm not going to call it anything. I would describe it to the [Congressional] Committee as a reasonable picture of the general zone in which we'd like to be as the year progresses.

MR. BLACK. Mr. Chairman, are you aware that there's a brand of golf balls that has truncated-cone dimples?

CHAIRMAN VOLCKER. Actually, I think I drew a picture like this once without consulting this Committee. I was probably using it in testimony.

MR. BOEHNE. So, this is sort of half rebasing and half not.

CHAIRMAN VOLCKER. I don't think it's--

MR. PARTEE. No, it's not really rebasing.

MR. MARTIN. It's not rebasing.

MR. PARTEE. It makes a lot of sense, actually.

CHAIRMAN VOLCKER. I think it recognizes that we wouldn't draw it that way unless we wanted to convey a notion that we were relaxed about being above this cone for a few months, or for the first half of the year or something.

MR. MARTIN. Under other circumstances one might draw the geometry the other way.

CHAIRMAN VOLCKER. The other way. I think it depends upon the substantive decision as to what kind of policy we want to--

MR. MARTIN. It conveys it a lot better than a geometrically neutral form, if you would.

MR. PARTEE. Are you talking about that for all the Ms or only for M1?

CHAIRMAN VOLCKER. For M2 we might just draw the parallel lines, I suppose.

MR. PARTEE. They're definitely pretty close.

CHAIRMAN VOLCKER. It's so close it makes practically no difference. For M3, I don't know what you want to do. We can draw parallel lines, I guess, and a cone. Mr. Sternlight, I have a note indicating that you wanted to talk.

MR. STERNLIGHT. No sir.

CHAIRMAN VOLCKER. I don't think we have to decide just at the moment, but we have to talk about it and decide when we come to the decision on what the targets should be precisely and what to say in the directive. We can just do it. One way of finessing this, which we did once, is to draw the parallellines and the cone--which is what the staff has there.

MR. GUFFEY. Have both.

CHAIRMAN VOLCKER. Yes. Well, we could just draw the parallel lines.

MR. GUFFEY. Have both.

CHAIRMAN VOLCKER. I'm pretty [easy-going] about all this. It doesn't--

MR. GRAMLEY. If we have both, you can do the kind of shading you want with words; and you'll tell a lot more about what our thrust in policy is than in any kind of picture we can draw. If we draw this strange looking picture, you're going to spend about 6 pages of your testimony trying to explain to Congress what that crazy thing is. If we draw both the dotted lines and the cones and then you say "Look, we started off rapidly--"

CHAIRMAN VOLCKER. The Wall Street Journal won't know what to put in their article! They'll have to reprogram it.

MR. GRAMLEY. I'm not sure I could figure out what mathematical equation would describe that animal.

CHAIRMAN VOLCKER. It's not a mathematical equation; it's a pragmatic line.

MR. PARTEE. Joined at the top of last year's range is the top position.

CHAIRMAN VOLCKER. Besides, it's probably not just a truncated cone but--

MR. PARTEE. The end of the year.

MS. HORN. The top of the midpoint of the fourth quarter.

CHAIRMAN VOLCKER. A skewed truncated cone, with different slopes on both sides.

MR. MARTIN. The Volckergram!

CHAIRMAN VOLCKER. There's also the question of what weight to put on M1. But it's getting late. I don't know whether there is some spontaneous consensus on the range itself. We can decide it tomorrow morning unless a spontaneous consensus emerges. If I recall [our discussion at the December meeting] correctly--though nobody is bound, obviously, by what he or she said last time--in a vague way the predominant support was for alternative II but there was some support for something that would look at least partly like alternative I. I don't think anybody was arguing for alternative III, although somebody may have said that the ranges should be tightened. I don't know; I don't remember that closely. Nobody is bound by that anyway. We'll narrow it down anyway. Is something less than alternative II in the ballpark?

MR. MARTIN. I join President Balles in the caveat that, to the extent that alternative II is beginning to emerge as a consensus, I think we may have pragmatic difficulties with the upper bound of M1. Given the staff forecast of income and interest rates, their warning that the projections on velocity have some confidence limits around them, and given the lagged effect of the interest rate drop that we've had, V1 could even be a little negative next year. If we're going for alternative II--as I hear you, John--it seems that we ought to do something about the upper boundary for M1; 7 percent may be too low.

CHAIRMAN VOLCKER. I wouldn't--

MR. WALLICH. Well, I don't see the setting of these targets as a means of accommodating the economy. We're setting the targets so as to shape the economy.

MR. MARTIN. I'd like to see us shape the economy with a 4 percent real growth rate, Henry.

MR. WALLICH. Well, that's not my objective.

MR. GRAMLEY. If you look at where our projections were last July when we first set these targets versus where they are now, the median forecast for real GNP looks like it might be half a percent or so higher than it was then. For the GNP deflator it looks like the median forecast is going to be about 1-1/4 to 1-1/2 percent lower. So, we have more real money balances assumed and a larger real GNP growth and it seems to me that we would have a heck of a time explaining to anybody why we raised the targets for money growth. I think we could sit with these.

MR. MARTIN. Lyle, we're not raising the targets; we're lowering them by 1/2 a point for M1. I would suggest 7-1/2 percent to go along with the 8-1/2 percent on M2. That would be taking the upper limit 1/2 point [above the tentative target] and a 1/2 point [below

the target] the year before. It gives us a little room. We're talking about being around the upper limit of each of those ranges.

MR. GRAMLEY. It's room I don't think we need. And I think we send the wrong kind of signal when, after having set these targets initially, we're forecasting more real growth and higher growth of money balances with the lower GNP deflator. I don't see that we need that additional freedom. And I would prefer to send a signal which says: "Look, we're still concerned with bringing down growth of money and credit over the long run to bring down inflation."

MR. MORRIS. I think there's a good argument for not changing anything in that we don't have the faintest idea what the velocities are going to be anyway. Therefore, why not--

CHAIRMAN VOLCKER. But we're going to shape the economy anyway.

MR. MORRIS. And I don't see any point in changing the debt range because, historically, an 8 to 11 percent range for debt gives a lot of room for 8 percent nominal GNP growth.

MR. PARTEE. It just hasn't in the last few years.

CHAIRMAN VOLCKER. Well, this may be a little side issue. It didn't last year and maybe the year before; I don't remember. But I was a little struck too when somebody--Mr. Axilrod, I guess--said that, obviously, we can't lower that unless we're going to say something about all these mergers and so forth. Why is the analysis so certain that what we have for nominal GNP growth--7 or 8 percent or whatever--is going to produce 11 or 12 percent debt growth when that's out of keeping with 90 percent of history? It is not last year's history, I agree; but what is the analytic background? Is it the deficit? Is it a high deficit that produces that? I don't know.

VICE CHAIRMAN CORRIGAN. No, because if it were 8 percent nominal GNP growth, particularly in a more mature stage of the business recovery, normally the deficit financing this percentage of GNP would be down. I think that's why the predicament of this overall credit market situation is so hard to--

CHAIRMAN VOLCKER. What you're saying may be true; I'm not sure what it is--that the dollar of government deficit produces more debt than the dollar of private deficit?

VICE CHAIRMAN CORRIGAN. No, I'm saying--

MR. MORRIS. If there is a difference from the historical [experience], it's the fact that our total expenditures are running substantially above the GNP.

CHAIRMAN VOLCKER. That's one reason.

MR. MORRIS. Therefore, you could argue that you need more debt. But don't you also need more money? Why do you need more debt and not more money to finance a greater level of expenditures? It's not immediately apparent to me.

MR. BALLE. Velocity is down.

CHAIRMAN VOLCKER. Well, we're throwing out two questions to the staff now. We'll get a response and go home. Maybe it's--

MR. RICE. Well, maybe part of it--

MR. AXILROD. The staff was tempted to suggest throwing away the debt variable as not being useful.

MR. BALLE. I second that.

MR. AXILROD. President Morris mentioned one thing. In some research we've done, the debt does seem to run a little better relative to total spending than it does to GNP. So that gives you a percentage point. Last year we thought the mergers and acquisitions added about a point. I threw in a quarter of a point for the acceleration of state and local government borrowing.

CHAIRMAN VOLCKER. That's 2-1/4 points.

MR. AXILROD. I think you can throw in another tenth or two for those HUD notes that came at the end of the year. I didn't throw that in there. I personally believe that the government deficit does get you greater credit growth relative to GNP, though it's a little hard to find it in the data. Of course, we haven't had so many years with these big deficits. You can base it partly on the grounds that the government does [not] really have the option to finance itself by (a) issuing equity or (b) drawing down assets. Now, the private [sector] can't draw down assets forever, but they have that [option] as well. So, we really have reduced the credit growth by roughly the same amount as we reduced nominal GNP. When we worked through the whole flow of funds, we had a hard time getting any less credit growth than that, going through it sector-by-sector and taking all these things I've mentioned into account. I think we have about 1/2 point or so in there for mergers and acquisitions. That would be my response. I don't know whether Mike or Jim has anything to add to that.

MR. PRELL. We had some discomfort about the overall debt growth relative to GNP. But we also know, as President Corrigan pointed out, that we have had this very strong trend over the past two years. In arithmetic terms it seems to have been related to this unusual Federal borrowing, and that will continue. We just couldn't really find the basis--in terms of a set of credit flows consistent with our sectoral picture and the GNP forecast--for squeezing out much more debt in the household sector and the business sector. I must underscore that the assumption we made about mergers and acquisitions and so on is rather arbitrary. We don't see the pattern clearly yet, and it's not inconceivable that we could get a larger amount.

CHAIRMAN VOLCKER. Just to clarify it in my mind: What would your straightforward projection of debt be consistent with your whole model and whatever mergers and acquisitions you allowed for?

MR. AXILROD. 11.7 percent.

CHAIRMAN VOLCKER. 11.7 percent, which includes 1/2 point for mergers and acquisitions.

MR. AXILROD. Roughly.

MR. PRELL. There's no model; this is purely judgmental.

MR. KICHLINE. And that's 2 percentage points less than a year ago.

CHAIRMAN VOLCKER. But with a lower GNP.

MR. KICHLINE. It was 13.6 percent in 1984.

MR. PARTEE. And 2 points less in the GNP growth.

MR. PRELL. It's a comparable excess over GNP growth.

MR. KICHLINE. Let me make one comment on the Federal side. I was looking at the numbers back in the 1975 through 1978 period; in 1978 Federal debt was growing at under 10 percent--more like 9 percent. This time, in 1985, we are still facing 15 percent rates of increase. We have come down from 19 percent to 17-1/2 percent to 15 percent. Those are very large numbers to deal with and see the total decline.

VICE CHAIRMAN CORRIGAN. Yes. And even in 1975, on that chart we had earlier, the big spike in government borrowing was accompanied by a corresponding downward spike in private borrowing.

CHAIRMAN VOLCKER. That's what you'd think might happen normally. Well, let's stop for the evening unless somebody has something further they want to say.

MS. HORN. Have you heard anything about transportation to the Embassy tonight?

MR. BERNARD. There will be cars at the hotel at 7:15 p.m.

[Meeting recessed]

February 13, 1985--Morning Session

CHAIRMAN VOLCKER. We were in the midst of discussing these long-range targets, but maybe we can interrupt that for Mr. Kichline's report on the only new economic news we got overnight. Why don't you insert that at this stage?

MR. KICHLINE. We have the advance retail sales number for January, which is that total sales are up $3/4$ of a percent. But there were downward revisions for both November and December. The group, the so-called retail control--excluding autos and gasoline stations and nonconsumer sorts of things--was down 0.4 percent in January. More importantly, December was revised down to minus 0.2 percent; it had been plus 0.6 percent. And there was also a downward revision in November. Basically, the staff had assumed monthly increases of around 0.5 percent in the first quarter. That would have put the January level of this so-called retail control about 1.5 percent above the fourth-quarter average. Taking these numbers as they now stand, January is 0.1 of a percent below the fourth-quarter average. So, these numbers are appreciably weaker. Who knows what they will be 3 or 4 months from now when they're revised? But this is certainly not a bullish report.

MR. PARTEE. Was the November revision significant too, Jim?

MR. KICHLINE. Yes. For total sales they had been showing a 2.0 percent increase; it's now 1.5 percent.

MR. PARTEE. I see.

MR. KICHLINE. For this retail control, it was up 1.6 percent and it's now up 1.3 percent.

MR. PARTEE. So, it really has drifted quite a lot lower.

MR. KICHLINE. Correct.

CHAIRMAN VOLCKER. We were discussing what the long-range targets should be. I think the conclusion has been reached not to rebase, though some imagination in drawing lines may be desirable. We were on the subject of what the targets should be. There was some expression that they ought to be the way they are in alternative II and some expression that at least M1 ought to be a $1/2$ percentage point higher on the upper end. There was one expression of that view. Does anybody else have anything to say? Mr. Rice.

MR. RICE. Mr. Chairman, given the forecasts that we've made --noting that nobody expects real growth less than 3 percent or in excess of $4\frac{1}{2}$ percent--I think alternative II looks very good. It seems to me that the ranges proposed for M1 and M2 would accommodate growth within the range of 3 to $4\frac{1}{2}$ percent. I'm quite comfortable with a range for M1 of 4 to 7 percent and for M2 of 6 to $8\frac{1}{2}$ percent. I could live with the proposed ranges for M3 and total credit, but I would prefer to see M3 raised $1/2$ of a percentage point to $6\frac{1}{2}$ to $9\frac{1}{2}$ percent and credit at 9 to 12 percent. We expect M1 to come in near the upper reaches of the range. And while we hope that M3 will also be in the upper part of the range established, we have this experience of M3 running very high. And I don't see why we

should not set the ranges so that M3 will be at least closer, if not within, the range. The main objection to that seems to be that this would transmit a signal to the public that we are not being sufficiently vigilant or, in the case of total credit, that we're trying to accommodate the deficit. I myself am not impressed with that argument. It seems to me that the public cares most of all about M1 and, to some extent, M2. But I don't believe the public would be alarmed if we recognize that M3 is tending to run very high relative to its range as it has in recent months and that we allowed for that by increasing the band to 6-1/2 to 9-1/2 percent. I would favor also a range for total credit of 9 to 12 percent.

CHAIRMAN VOLCKER. Refresh my memory, Mr. Axilrod. Do your technical gnomes think that M3 is [more] likely to run high relative to its range than M2?

MR. AXILROD. I think the difference in our point estimates is trivial. Our point estimate for M2 is around 8 percent and our point estimate for M3 is close to 8-3/4 percent. I would say that the best way to think of it is that M3 looks a shade closer to the upper end than M2, but I would have some doubts that M2 will run quite that low--

MR. RICE. But, Steve, doesn't that depend in part on the assumption of higher interest rates as the year goes on?

MR. AXILROD. That's right. We have a slight drift up in interest rates, which was--

MR. RICE. But your assumption that M3 will stay within the range is based on your expectations that interest rates will--

MR. AXILROD. Yes. I would say that's equally important to M2.

MR. RICE. It may not happen.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. Well, I would prefer the ranges actually adopted in mid-1984, although I'm a little agnostic on some shading of those targets insofar as they pertain to M3 and total credit. But, in particular, I would not want to see the M1 range for 1985 different from the 4 to 7 percent. If M1 were at the top of that range, at 7 percent, that would permit an 8 percent rise in nominal GNP with only a 1 percent increase in velocity. And that's not unusual, even for the third year of economic expansion. On the other hand, if inflation could actually be lower than 4 percent or so--as some people suggest--then that kind of a result could occur with even less than a 1 percent increase in velocity. More importantly, if it worked out during the year that velocity wasn't growing at all but was declining, I think it would be a heck of a lot easier to adjust in that direction--even if it meant being above the range, which I think is unlikely--than to have to adjust the other way. [By other way, I mean] having money growth at 7-1/2 or 8 percent, which would still be in the target range but in a context in which it turns out that velocity is increasing and nominal GNP is growing too fast. So, I feel somewhat strongly about that one in particular. In general, I

prefer something like alternative II or the ranges we adopted tentatively in July--again with some agnosticism on credit and M3.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. Mr. Chairman, I would echo Governor Rice's comments with regard to the understandable shift in our views toward the probability of a bit stronger growth. It seems to me that in our discussion yesterday, something like half of us were talking about growth of 4 percent, or at least higher growth than the staff forecast. It's obvious also in the tabulation done for the July [Humphrey-Hawkins] Report to the Congress vis-a-vis our most recent tabulation that there has been a shift of 1/2 or 1/4 percentage point, or something of that magnitude. That says to me that there is a stronger possibility than existed before that M1 growth for 1985 will not only run above the 6-1/2 percent but that it could easily run 7 or 7-1/2 percent. We still don't know what the lagged effect will be of the drop in short-term rates which, after all, was a very substantial drop. It hasn't worked its way through and we don't know what that will do to velocity. And we can't escape the din of news with regard to the strength of the dollar and the [unintelligible] that's in that news from time-to-time of almost a scramble for dollars in this or that market. It seems to me that we easily could have a 7-1/2 percent rate of growth in M1, which would be consonant with a favorable inflation outlook and export performance. Regardless of the geometry that we're presenting on this and that The Wall Street Journal is picking up, the implication at least is that M1 will be running above the 7-1/2 percent level and that there will be implicit or explicit pressure on us to adjust.

I favor [an upper limit of] 7-1/2 percent with some comments with regard to some of these matters that have developed since July. Goodness knows, there have been enough developments of substance since we reported to the Congress in July to risk breaking a precedent! My understanding is that we don't change these outer boundaries of ranges of monetary aggregates once they are set; I don't see why we should be confined to that kind of a pattern. I suggest that we use 7-1/2 percent [as the upper limit] for M1. I think some of the same comments could extend to M2. It may run at or above the upper limit that we set in July. The 8-1/2 percent doesn't seem to be as important in the way the market looks at the monetary aggregates. We have to think of how they--the traders, the market makers--think. I would extend that even more so to M3 and to total credit. I'm not ready to jettison total credit as was suggested yesterday. Obviously, we don't seem to be gipped in the market and in the market comments when we exceed the latter two broader measures. So, I would opt for an upper limit of 7-1/2 percent for M1 and leave the other three ranges where they are.

CHAIRMAN VOLCKER. I don't know what historians we have here. How much have we changed these ranges? Do we never change them? We [unintelligible]--

MR. AXILROD. We have changed the tentative ranges. We have to check back; we can do that.

CHAIRMAN VOLCKER. I think we have, but not very frequently.

MR. AXILROD. We'll check back on it.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. I think there's a lot to be said for the 4 to 8 percent range on M1. My particular point estimate is 8 percent on nominal GNP, and if we have the 1 percent increase in velocity that the staff is predicting, that will result in a 7 percent [M1] growth rate, which would be consistent with that. That's at the very upper end of our 4 to 7 percent range and a 4 to 8 percent range gives us a little room. And it seems to me that it's more likely to fit suitably in a year which--if it comes out as we are projecting it--produces suitable results of 4 percent or thereabouts on real growth and 4 percent or maybe a little less than that on inflation. I don't see why in advance we should show some inclination to try to screw down on the economy with this kind of a prospect. I also think it would look good from the standpoint of the public because we're saying: "Look, inflation has developed quite a bit better than we expected." Although it's not zero, as Henry keeps pointing out, it looks like it's going to be a quiet period and we don't want to stop the economy from having reasonable growth. Therefore, since the problems haven't materialized that we were beginning to anticipate when we cut that range back in July, I think there's a lot to be said for putting it back where it was before, at 4 to 8 percent. It could be played very well. Therefore, I think that's what we ought to do.

I don't think we ought to get into some kind of a box on these other Ms because we're trying to be tight about everything. So, taking 4 to 8 percent for an M1 range, I also would take the rest of alternative I for M2 and M3. Maybe total credit ought to be 9 to 12 percent rather than 9-1/2 to 12-1/2 percent, but I see nothing wrong with that in the context we're talking about. Now, if our forecast turns out to be seriously in error, that upper limit will give us a constraint. If more inflation begins to develop, we'll start to pop over the upper limit and that will be the basis for snuggling up in the market. On the other hand, if the staff is wrong on velocity and it goes up 2 percent or 3 percent rather than 1 percent, there's no reason we can't fall below the 7 percent normative number that I have now in my forecast and take 6 or 5-1/2 percent. That's within the range we're talking about. So, I think the 4 to 8 percent range fits very nicely with the economic circumstances that we're talking about for this particular year, and I would support that.

CHAIRMAN VOLCKER. Velocity went up 4 percent last year. Mr. Black.

MR. BLACK. Mr. Chairman, I come out in a different place than most of the others. I think we've done remarkably well with monetary policy the last year and a half, so far as M1 is concerned in particular. We've about hit our targets right on the button; we were a little off last year, but not a great deal. Accordingly, I think it's important that we continue this progress that we've made and I would go with alternative II. I accept the staff's suggestion that we increase the monitoring range [for total credit]. But I would strongly prefer that we omit any reference to coming in at the top part of that [M1] range. If we hit the 5-1/2 percent midpoint, that's a little pickup from what we had this past year; and with the economy still apparently strong, I just don't think any useful purpose would

be accomplished by suggesting that we were aiming for the top portion of the range. I think it might undermine some of the progress we have made in increasing our credibility in the last year and a half.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, I too would prefer to see M1 remain in the 4 to 7 percent range for the reasons that have already been expressed. And I would add just two. First, I think that inflation expectations are better than they have been in the last couple of months and, therefore, we'll have more rapid growth in real balances that will give us a little more leeway at the top end of the range. Also, to raise the M1 range to 4 to 8 percent at this time would express more concern about the economy than our projections would seem to indicate. I just have a feeling that moving it to 4 to 8 percent at this point could very well send the wrong signal to the market. For that reason I would prefer to keep the range where it is with the expectation that we probably would come in at the top of the range in any event. I think M2 also should follow the specifications of alternative II. With respect to M3, I have a slight preference for moving the range up to reflect the reality of the situation that we've had over the past several months, and I would suggest a range of 6 to 10 percent or perhaps 5-1/2 to 9-1/2 percent for M3. I think total credit perhaps should be widened also, say, to 8 to 12 percent, although the 8 percent is probably not a very significant number. But I think we need to move the top end, again to reflect what actually has been going on.

CHAIRMAN VOLCKER. Anybody else have any comments?

MS. HORN. Mr. Chairman, I also support alternative II and the 4 to 7 percent range for M1. There may be reasons--Chuck and Pres have talked about some of them--why M1 indeed probably would come in toward the top part of the range. Nonetheless, with the uncertainties that we face--[the age of] the recovery, velocity, exchange rates, and so forth--I'd like to see discussion in the presentation of these ranges that is a little more symmetrical. While it certainly would refer to the top half of the range, I'd favor some discussion about the uncertainties and what kinds of things might have us choose to come in at the midpoint or even lower as the year progresses. The other reason that I favor the 4 to 7 percent range is that I think the statements about our long-term disinflationary goal sometimes get buried as we talk about some of the more immediate kinds of problems we have. And I think it would be a good place and a good way to restate the long-term goal that we have.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. As far as M1 is concerned, I'd be inclined to split the difference between alternative I and alternative II. I think we do have a reasonably favorable outlook for 1985 in terms of real growth and inflation. And I think we ought to take favorable things as they come along and not clamp down. Alternative II is just too snug a fit as far as accommodating what seems to me a pretty good outlook; we need a little breathing room at the top. Also, I would remind the Committee that 7-1/2 percent is not an increase; it's a decrease over what the range was for 1984. I agree there is something to the long-run goal of ratcheting these numbers down. But our goal

was 4 to 8 percent last year; it was not something less than that. So, it seems to me that splitting the difference gives us the advantage of paying some allegiance to our longer-run goal of ratcheting these numbers down while at the same time providing some breathing room to accommodate what I think is a fairly favorable outlook.

MR. AXILROD. As it turns out, Mr. Chairman, it's more usual to change the tentative ranges than to adopt them. Of the four relevant years--1981 through 1984--only in 1982 were the tentative ranges agreed on [in July] adopted [the following February]. In 1981, 1983, and 1984 they were changed in varying ways. In 1983 there was a substantial change in M1: that's when it was reduced to a monitoring range and was raised to 4 to 8 percent as compared to the 2-1/2 to 5-1/2 percent tentative range. In other [years] the changes were in M2 or other broad aggregates.

MR. MARTIN. Good report.

CHAIRMAN VOLCKER. We changed M1 only once?

MR. AXILROD. As far as I can tell, I think that's right.

MR. RICE. The change [unintelligible] circumstances.

MR. BOEHNE. Even central bankers change their minds!

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Well, Mr. Chairman, I would be with those who endorse alternative II. It seems to me that the reasons are very compelling to utilize that alternative, and I'm not sure I'm impressed by any compelling reasons to make a change at this point. The economic outlook as we discussed it around the table seems pretty solid. The inflation outlook is not unreasonable, although it certainly continues to be an area that we need to focus on. And the velocity patterns seem to be more predictable than has been the case. So, I would be in favor of alternative II. I certainly would think that raising the M3 and credit aggregate ranges would be appropriate. And I think we should begin to place much greater emphasis on M1 and that that should be clear in the message that you will be giving. I would think that the longer-run objective for the year ought to be toward the middle part and I would prefer that we not necessarily specify that we would be in the upper or lower part of the range. I would be bilateral on that, depending on how the velocity outlook develops during the year. Our objective should be toward the middle; by so doing, we continue to give emphasis and credibility to the objective of returning to reasonable price stability.

CHAIRMAN VOLCKER. Mr. Wallich.

MR. WALLICH. I continue to think we ought to have our monetary targets and try to make the economy, and mostly inflation, conform to them. I think we are in some danger of adapting the targets to what we think is ahead in the economy. The only reason for doing the latter, it seems to me, is a concern about high interest rate problems for farmers, developing countries, or the dollar. Those are important. But somehow it seems to me that if we now raise our

targets, we're in effect saying that we're going to maximize as best we can the expansion of the economy and maintain interest rates as low as is consistent with continued rapid growth rather than focus on the objective of inflation. I think inflation is the least achieved of all of our objectives even though it has been better than we expected. But the same is true of unemployment and growth; we have done better on each front than we expected. But in absolute terms we are farther from a good condition on inflation than we are, say, on unemployment and the use of the economy's potential. So, I would stay with alternative II, and where there seems to be a misfit such as on M3 and total credit, I would nevertheless stay with these ranges. I think they are telling us something; they are not just something that needs to be made to fit what the economy does. If they don't fit, they're telling us that credit is expanding at a rapid rate which at some time in the future will cause us trouble. And we should recognize that. Neither, therefore, would I aim at the upper [end of the] range. I would say that 7 percent plus 1 or 2 percent velocity gives us plenty of room. I would, therefore, accept alternative II exactly as it is. Thank you, Mr. Chairman.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. I also would choose alternative II for a couple of reasons. One, if we raise the range even to 7-1/2 percent--which I recognize is a move down from the 4 to 8 percent--or if we move to an 8 percent limit on the high side, as has been suggested, I believe we're really saying that we've done our job on inflation and we're willing to accept inflation at roughly a 4 percent level or perhaps a little above. And that's a view that I would not want the Committee to give to the public; I would not want to permit that kind of interpretation. Secondly, as to the ranges themselves, it seems fairly clear from the discussion yesterday and from the projections that 4 to 7 percent will accommodate the growth in nominal GNP that we're looking for with the level of inflation we're expecting. And if it doesn't, as we have done in the past, we can talk about the upper part of the range. I would emphasize looking for growth near the midpoint, but I'd be willing to go to the upper part of the range providing velocity doesn't perform as we are projecting. As a result, it seems to me that these ranges accommodate what we're looking for. I would like to have the top at 7 percent, therefore providing some restraint in the event that the projections don't come through. Lastly, I'm not very concerned about M3 or credit; so the ranges, whatever they may be, are perfectly all right with me. For M1 and M2 I would prefer those in alternative II.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLEs. Well, Mr. Chairman, as we all know, these ranges serve many masters. One of the masters is the general impression of the public as to our long-run game plan--which has been expressed so well by you over the years--to reduce gradually over time the rate of monetary growth and get it down to noninflationary levels. For that reason I think it is important, if only symbolic, to lower the upper end of that range a touch. Going down to 4 to 7 percent, however, brings up the problems that I talked about yesterday and that Governors Martin and Partee ran off very well today, so I won't repeat what those problems are. As I mentioned yesterday, our staff forecast shows money running considerably over the upper end of the 4 to 7

percent range for a good part of the first half of this year based on the present level of interest rates. To keep that from happening, our staff thinks we would have to get a very considerable increase in interest rates. That is on the assumption that the velocity of money is going to be declining during the first half of the year. Putting all that together, I would come out in favor of a 4 to 7-1/2 percent range. Although a case could certainly be made for 4 to 8 percent, I would prefer the 4 to 7-1/2 percent simply because of the public perception that we are gradually making some progress in reducing the upper end of that M1 range. And it is my understanding that the financial community certainly pays a lot more attention to M1 than they do any of the other Ms. I share President Guffey's views on M3 and total credit: it probably doesn't make much difference. But I would adopt the M2, M3, and total credit ranges of alternative I, simply to get back to reality a little. That would be the total picture I would recommend, Mr. Chairman.

CHAIRMAN VOLCKER. Mr. Garbarini.

MR. GARBARINI. Mr. Chairman, the heart of the Midwest continues to dance to a rhythm that I believe the Chairman has played over the years, which leads us down a road called "reduced inflation." We would support alternative II and hope that we would not signal that we will be in the higher end of the range.

CHAIRMAN VOLCKER. Miss Seger.

MS. SEGER. I support alternative I. I'll just say "ditto" to Governor Partee's comments plus add another observation about M1. And that is: In 1984, using the revised numbers, M1 growth was 5.2 percent, which was 0.8 below the midpoint of last year's goal, if I did the arithmetic correctly. I know we decided not rebase. Still, if the targets for last year were appropriate and if that's the way M1's actual performance came in, then I don't think we should ignore that when we set the targets for this year. Therefore, I would like to add that to all the other reasons for having the M1 range at 4 to 8 percent. Also, as I listen to comments--and I also went back and re-read materials for the last two years--I'm not convinced that we really have identified in any exact way the relationship between money growth and the economy. I don't think we always know what's going to happen to velocity; we may think we do, or would like to, but I don't think it works out that way. So, maybe it's more honest to send a signal that we don't have these precise measures and, therefore, we will go with broader bands.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Well, Mr. Chairman, I would join those who are arguing for alternative II, and I would be willing to take it the way it's specified in the Bluebook. I really have no additional justification for that other than I think it allows for adequate money growth. I do think that the perception is always important and it is certainly important right now. I think that would convey the perception that I'd like to see us convey.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. I tend to think of these longer-run ranges the way Karen Horn does. They tend to send a message about what our strategy for monetary policy is over a longer period. And I really think there's a complacency developing in our country about this inflation problem. I just don't think we can afford to decide, even implicitly if not explicitly, that we don't need to be concerned about this inflation problem anymore. I'm a bit puzzled when people say 7 percent growth in M1 is a constraining influence on the economy. If our forecast for prices is half-way honest, we're talking about a 4 percent increase or less, and a 7 percent increase in nominal M1 provides for a 3 percent increase in real money balances. If you look over the trend of the past 20 to 25 years, you'll find that the growth rate of real M1 has a trend of less than 1 percent a year. So, I would like to stay with these targets. If the economy turns out nowhere near the lines of the staff forecast and it's much weaker, I would be prepared later on to see growth of M1 exceed that upper limit; but I don't want to send that kind of message now.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, I agree with Governor Gramley. From the standpoint of the effect on expectations, I think it is wise normally not to change the guidelines unless there is a compelling reason, and I don't see a compelling reason to change the guidelines. If we get trend velocity we can finance an 8 percent nominal GNP rise very comfortably within the alternative II guidelines. I don't know whether we're going to get trend velocity or not. If we don't--if we get an aberrant velocity behavior--we may have to change the guidelines within the year. But I don't think we ought to assume anything other than trend velocity at this point in time. And I think alternative II would meet our economic objectives very easily given that assumption.

CHAIRMAN VOLCKER. Mr. Gainor.

MR. GAINOR. We would line up with those who favor alternative II. Our forecast shows very favorable growth, even with that range, and we think it's appropriate.

CHAIRMAN VOLCKER. There's a tremendous unanimity among nonmembers.

MR. BLACK. That augurs well for next year!

CHAIRMAN VOLCKER. I think we get into this problem partly because I suspect the inflation forecast is too high--not to beat a dead horse anymore. There's room for real growth under any of the alternatives in here [if we had] more modest inflation assumptions. The choice boils down to this. I'm not going to make everybody happy; we have four targets here and 12 members and the permutations and combinations of that grouping are enormous. The only proposal I can make is to stick with something like alternative II; I don't know how many people that would make directly happy. Most people have been focusing on M1, so we can talk about modifying some of those other ranges if that's important. But I would also say that we ought to give the message--we do that in the short-term targets, I suppose--that we don't mind being above that cone for the time being. I would be inclined, in the interest of reconciliation if nothing else, and it

may be meaningful, to put a sentence in the directive indicating that we wouldn't necessarily be unhappy if growth were in the upper part of the range. I don't like the sentence that's there now; and I don't know why we should single out M1 given all the comments either. I'd have a sentence to the effect that: "The Committee agreed that growth in the monetary aggregates more generally in the upper parts of their ranges for 1985 may be appropriate, depending upon" something. One approach would be to use "provided inflationary tendencies remain subdued." But I might say something about business too. I don't know quite what we should say. I don't think we want to say "would be appropriate provided business is weak." That sounds a little odd. It's the fact of the matter, but it might suggest we're anticipating something in that connection.

Let me just try this. We have a majority that wants something like alternative II; it's not a very large majority but some of those said they didn't want to put in anything about being in the upper part of the range. The obvious accommodation is something like alternative II but some acknowledgment that growth in the upper part of the range might be possible. I wouldn't put it as an aim; I'd say it might be appropriate under certain conditions. An alternative, as has been expressed, is to go to something like 4 to 7-1/2 percent and not say anything about being in the upper part. Let me try broadly those two alternatives. We'll return to fine tuning M3 and credit later. Looking at M1: Who would have a preference for leaving it at 4 to 7 percent but with some acknowledgment--the precise language to be determined--first of all, that running above the range now isn't horribly prejudging the short-term decision; and secondly, that we wouldn't be amazed and may well find it desirable to be in the upper part of the range, depending on how things develop? To have a specific acknowledgement of that is one alternative. The other alternative would be just to go to 4 to 7-1/2 percent and leave it at that.

MR. GUFFEY. With respect to the first alternative, are you contemplating putting it in writing or doing it in your testimony?

CHAIRMAN VOLCKER. Right now I'm contemplating putting it into writing.

MR. GUFFEY. Well, you're going to testify within--

CHAIRMAN VOLCKER. It could be done in the testimony, but what I'm proposing at the moment is that some sense of that be written into the directive.

MR. GUFFEY. I'd prefer not to go that way. I'd rather go to the 7-1/2 percent, if those are the only alternatives you are suggesting.

CHAIRMAN VOLCKER. Well, I guess I want to concentrate on the members at the moment. Who would prefer what?

VICE CHAIRMAN CORRIGAN. I have a strong preference for the first.

MR. PARTEE. I have a strong preference for the second.

CHAIRMAN VOLCKER. Well, let's raise hands. How many have a preference for the first? Five. How many have a preference for the second? Five.

MR. WALLICH. I don't need to have a preference for either, do I?

CHAIRMAN VOLCKER. Two things were presented to you. I don't know what you like and [unintelligible]. If you have another preference that commands more support, that's--

MR. WALLICH. Without committing, if I had to choose between the two, then I would take the first.

CHAIRMAN VOLCKER. Well, let me go to the fine tuning. What do people feel about M2 or M3 and total credit? I don't know that we really want to raise the range for total credit; it's already awfully high. It may be exceeded. I don't know what kind of messages we would be sending by raising the total credit figures at this point.

MR. PARTEE. I think it's a recognition of the unexpected size of the inflow of capital from abroad.

VICE CHAIRMAN CORRIGAN. Are people talking about 9 to 12 percent?

MR. PARTEE. Pardon?

VICE CHAIRMAN CORRIGAN. Were you suggesting raising that?

MR. PARTEE. To 9 to 12 percent.

MR. RICE. I thought you were talking about 9-1/2 to 12-1/2 percent, as in alternative I.

MR. PARTEE. I said that seemed a little steep. But I was not speaking of the numbers; I was speaking of the reason why we would recognize that they were high numbers.

CHAIRMAN VOLCKER. I'm not sure of that reason, but he has me confused on it. Does anybody want to raise that from 9 to 12 percent?

MR. RICE. Does anyone want to raise it?

MR. PARTEE. Above 9 to 12 percent?

CHAIRMAN VOLCKER. Above 9 to 12 percent. All right, that's 9 to 12 percent. On M3 you expressed that opinion. Do other people want to raise the M3 range?

VICE CHAIRMAN CORRIGAN. I wouldn't be bothered by 1/2 point [higher] on that just because I'm not sure what's going to happen to it.

MR. GRAMLEY. Everybody knows we studiously ignore M3 anyway, so whether we have 6 to 9 percent or 6 to 33 percent or whatever--

MR. RICE. Since it doesn't matter, why not raise it?

CHAIRMAN VOLCKER. Then, nobody is bothered by raising it to 9-1/2 percent?

SEVERAL. No.

MS. SEGER. Did you say 6-1/2 to 9-1/2 percent?

CHAIRMAN VOLCKER. Yes. Well, 6-1/2 to 9-1/2 percent or 6 to 9-1/2 percent.

MS. SEGER. That's what I want; I want the 9-1/2 percent high end.

MR. BOEHNE. Why don't we make it 6 percent to whatever?

MR. MARTIN. 6 percent or more.

CHAIRMAN VOLCKER. M2?

MR. PARTEE. Well, I think we're going to have trouble with that at 6 to 8-1/2 percent. I would prefer 6 to 9 percent.

MR. MARTIN. I would too.

MR. BALLE. I would too.

MS. SEGER. I would too.

MR. WALLICH. I definitely would not. I simply don't understand why we have to raise all the ranges, or almost all of them, when we've had lower inflation than expected. It seems to me a devastating signal.

MR. PARTEE. It provides for a little more room for real growth.

MR. WALLICH. Sure.

MR. PARTEE. I don't see anything wrong with that myself.

MR. WALLICH. You want to maximize growth and take the inflation that that eventually would provide?

VICE CHAIRMAN CORRIGAN. The problem is that if you allow for real growth of more than 4 percent, I think you have to forget about the targets in one sense and ask yourself the question: What's likely to be going on in the economy over some period of time? I'm not talking about a quarter, but if over a period of time the economy is growing by more than 4 percent, it seems to me that in the circumstances we're faced with right now--leaving aside the magic of these targets--the outcome may well be one that is going to put more pressure on financial markets and interest rates. And it's going to subvert our effort to try and create a policy environment in which we can keep the economy growing at 4 percent for a long time. That's one of the things that worries me, Chuck.

MR. PARTEE. Well, to me 4 percent is desirable and 4-1/2 percent is acceptable. We're starting off with an unemployment rate

of 7.4 percent. There was talk about that being the full employment level; I certainly don't agree with that. I think we have room to go down; I don't think we know; we have to probe and see. I think we probably could have 4-1/2 percent growth for this year without difficulty.

VICE CHAIRMAN CORRIGAN. Again, that's another possibility. The problem I have is that the higher we set the targets the more difficult it will be to react in some coherent way if things break on the up side.

MR. PARTEE. But if they break on the up side, we're going to go right through the upper ends of these ranges.

CHAIRMAN VOLCKER. Well, we had 5.6 percent real growth last year and inflation at 3.5 percent with 5.2 percent M1 growth.

MR. PARTEE. A very unusual year. I don't think it will be repeated.

MR. BALLE. That's because velocity went up 4 percent, Mr. Chairman.

CHAIRMAN VOLCKER. I know it did. That's why--

MR. BALLE. If you believe it's only going up 1 percent this year, then you have to allow for more growth of money. I think it's--

CHAIRMAN VOLCKER. Who said it's going to go up 1 percent this year?

MR. BALLE. I said if you think it might. That's what I'm assuming ranges are for: to allow for realistic possibilities. We're not committed to go to the upper end by setting it 1/2 percentage point higher, but it allows us to in case that develops, as our staff and the Board staff seem to think is likely. If it doesn't, so much the better. We're not committed to going to 7 or 7-1/2 percent. Governor Wallich raised the question: Why are we increasing our ranges? My answer to that, Henry, would be that it appears to us that the demand for money is increasing and one should allow for that in the determination of the ranges. If we don't, I think we'll get the kind of results we did in the first half of 1982 when we tightened up at a time that, in my opinion, we should not have and we drove the economy into a deeper recession than might otherwise have been the case. And it was because, in my case at least, of a belated recognition that the velocity of money was declining. I don't want to make that mistake again.

MR. WALLICH. It wasn't declining last year; and 7 percent M1 growth was associated during the '70s with rapidly accelerating inflation.

MR. BLACK. Well, the faster the rate of growth in money the lower the velocity is going to be, necessarily; it's just an arithmetic truth. If we hit the top part of the target we're going to have lower velocity. If we hit the midpoint, we're going to have higher velocity. I think either way we can finance it. But if we hit the top part, then somewhere along the way velocity is going to return

to a somewhat normal pace, I would assume. And that's where the trouble comes in.

MR. MORRIS. I think we ought to have a lot of humility around this table in forecasting velocity. It seems to me that all we can do is assume that we're going to get trend velocity; anything else is pure speculation.

CHAIRMAN VOLCKER. The trouble is we don't even know what the trend is.

MR. BOEHNE. Well, I would think the more the humility you have the wider the range you would want.

MR. GRAMLEY. Why should we be more humble now than we were at midyear?

CHAIRMAN VOLCKER. Well, I'm going to defer this vote until we do the short run. Maybe that will put some light on what we should do. Will you introduce the short run, Mr. Axilrod?

MR. AXILROD. Well, Mr. Chairman, I will be referring, of course, to the table on page 10 [of the Bluebook]. Most of these alternatives, depending on what you perceive the Committee is willing to do for the rest of the year, would be consistent in the long run with the range of alternatives that the Committee is now discussing. In a sense, I suppose alternative B would be viewed as most consistent since that alternative assumes, if we're right about our estimates of M1 relationships to reserve conditions, very little change in underlying short-term interest rates and reserve conditions, typified by a level of borrowing in the neighborhood of \$300 million over the next several weeks. We expect that that would be doable with an 8 percent growth in M1. I might add, although I don't know if the chicken's entrails are [of interest] to the Committee, that our monthly model would suggest somewhat higher growth of M1 over the balance of this period--perhaps a couple of points higher. On the other hand, the quarterly model, left to its own devices, would suggest that growth over the quarter would be a lot less than we're estimating here. The growth implied here would give you a negative velocity--on the order of [minus] 1-1/4 percent--assuming GNP is about as we have projected now for the first quarter. That would be, in a sense, a partial offset to the positive velocity on the order of 3 percent in the fourth quarter and would be, on average, obviously close to 1 percent. We expect also a substantial slowdown in M2 and M3 growth in February and March largely for the reason given earlier: that the drop in offering rates on MMDAs and money market funds is catching up with the drop in market rates. Indeed, market rates have risen about 25 basis points recently so they are accelerating that catch-up. So, we would expect M2 and M3 growth to slow substantially. All this is assuming funds are trading around 8-1/4 percent and not the average of about 8-1/2 percent of the last two weeks. But those relationships, as the Committee knows, are rather loose and depend very much on how the market perceives money supply and business conditions and how that might feed back and be affecting Fed policy over the very short run. Mr. Chairman, that very briefly sums up the essential points contained in [the Bluebook].

CHAIRMAN VOLCKER. Apart from the numerology here, I think as usual the decision at the moment is: Do we want to tighten up, ease up, or leave policy unchanged in the immediate future?

MR. WALLICH. In terms of the level of borrowing, this is surely a policy that can hardly be eased any further. The borrowing figure is very low. In terms of the funds rate to which this borrowing relates, I think it's true that that's still a rather high number relative to the rate of inflation. I see no reason to want to raise the funds rate at this time, but neither would I want it to go down; nor would I want to do something with the discount rate. So, I'd come out with "B."

MR. PARTEE. I would agree with "B" also; I would agree with what Henry said--that the current situation is adequate. It looks as if we're getting a pretty good recovery, somewhat shaded by that retail sales report this morning. But the rate of growth still seems adequate. I would point out that we've been bordering on the high side of monetary growth and, when I say "remain unchanged," I have in mind a moving down in the rates of monetary growth of the sort that the staff is projecting for the quarter. If that didn't occur, I think it would give us trouble.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I ditto what Chuck just said.

MR. RICE. So do I.

VICE CHAIRMAN CORRIGAN. So do I.

MR. MARTIN. I go along with "B," Mr. Chairman. My only reservation with regard to "B" is what the band of confidence is around the 8 percent December-to-March number for M1. It seems to me that the odds are that M1 will exceed 8 percent. My only discomfort is that 8-1/4 percent may not be the correct fed funds rate for the short run; maybe it should be 8-1/2 percent. But I take it that there is enough flexibility built into our procedures [to allow for] an 8-1/2 percent rate if we need it to get 8 percent [M1 growth] or whatever that is--less than the 10 percent and 12 percent that we've been experiencing in recent months. Given that assumption, I would go along with "B."

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. I would go with "B" also.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I think it is desirable for us to try to end the year at the midpoint of alternative II, so I tend to favor the short-run M1 path of "C." By the same token, I have some leanings toward "B" too, because I don't believe it would be desirable necessarily to move to the kind of borrowing target that "C" contemplates in the Bluebook. Edging on up toward the \$400 million borrowing level would be as much as I'd want to do. Perhaps more important than that, I'd want those words on lines 93 and 99--where we have the choice between "would" and "might"--to be "would" in both

cases. I don't think we know which way it's going to be and I'd like to see us be prepared to move in either direction, if the aggregates are not staying on the target. I think the phrase at the beginning should be "increase slightly;" that would be preferable to what is shown in "C." And I would go with the funds rate range of "B" because I'm not thinking about very much action at this point and that ought to be fully adequate to encompass anything I have in mind.

MR. PARTEE. "Increase slightly" for pressure on reserve positions?

MR. BLACK. Yes.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLE. Well, Mr. Chairman, the same factors that influenced me on my views on the long-term ranges are coming into play, particularly in the short term here. My view, and I hope it is correct, is that we're experiencing an increase in the demand for money as a direct reflection and delayed reaction to the drop in interest rates in the latter part of last year. To slow money down from the rapid growth rates of December and January would require a considerable increase in interest rates, which I don't want to see, particularly in view of the precarious situation of agricultural loans, international loans--the whole shooting match. Therefore, for this period and this period alone, I would come out in favor of alternative A for the short-term specifications.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, of the three alternatives that you presented--tightening, loosening, or staying the same--I think the proper course for policy at the moment is steady as we go. We have another meeting of this Committee within a relatively short time, at the end of March. I think there is enough time to allow the situation to unfold and to wait and see what happens. If I have a bias, it would be for eliminating the tilt toward accommodation. And if we got [money growth] at the upper end of the range, I would hope that we would be prepared to move more promptly against that rather than the other way. But I think it is important that we stay steady for the time being, and I guess that's associated with alternative B and its specifications.

MR. GRAMLEY. Like Chuck, I'm worried about how fast money is growing now and I hope we're going to get that slowed down. I'm not at all certain that I know what level of the Federal funds rate is going to do that. I'm reluctant to see policy shift from one direction to another abruptly, and I can go along with "B" with the understanding that if, in fact, we get money growth above those numbers, we begin to snug up a bit.

I would like to call the Committee's attention to the language of the operational paragraph with respect to what it says about economic activity. I think we need a change there. What we have there talks about an easier policy in the context of sluggish growth in economic activity and greater restraint if indications of significant strengthening of economic activity occurred. If we leave that wording, it seems to be saying that we still think the economy is

sluggish and I don't think that's what we ought to say; we ought to have a more neutral set of phrases than that.

CHAIRMAN VOLCKER. Anybody else have anything to say?

MS. HORN. I favor alternative B. I do share concerns with some of the people around the table that we have had 3 months of strong M1 growth and that by the end of March it could be more like 5 months. And at that point my concerns would be greater about the direction of M1 growth. But for the time being I favor "B."

CHAIRMAN VOLCKER. Mr. Garbarini.

MR. GARBARINI. I would also favor "B," and I would pretty much echo Bob Black's comments: I also have a little more concern about the accommodation and, therefore, lean a little more toward "C."

CHAIRMAN VOLCKER. Miss Seger.

MS. SEGER. I can handle no change from the present [stance], if that's what alternative B is. I would be concerned, though, if no change brought about a substantial rise in the fed funds rate because of how that is interpreted in the markets as a signal of what we're doing and also because of the very severe problem with the super dollar and some of the other special factors that I've mentioned before.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. I'd also choose alternative B. The only question that I would have with respect to alternative B is the \$300 million borrowing level that the staff associates with an 8-1/4 percent funds rate. I would just point out the pattern of seasonal borrowing between now and the next meeting. If you just take 1984, for example, seasonal borrowing went to a very low level of roughly \$150 million by the end of the period. If we're at or near a frictional level of borrowing now and we get \$150 million of seasonal borrowing, then that suggests to me that the funds rate might well drop below the [8-1/4] percent. We would have a hard time holding it there without some additional--

MR. PARTEE. What is seasonal borrowing now--\$60 or \$70 million?

MR. KOHN. The level of seasonal borrowing has been about \$60 million over the past 4 or 5 weeks.

MR. GUFFEY. Yes, in January; and then historically it begins to move up. For example, at the end of March in 1984 it was \$150 million after starting the year at or about the same level [as this year]. So there's an increase of about \$100 million in seasonal borrowing alone, which may complicate Desk operations if [adjustment] borrowings are at or near a frictional level now.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Well, I was in favor of alternative II before and alternative B here seems to fit that pattern appropriately. So, for the reasons I've stated, I'd be in favor of alternative B.

CHAIRMAN VOLCKER. Anybody else? Mr. Gainor.

MR. GAINOR. We too would favor alternative B. If we were going to fine tune it, however, we would move to the direction of "C," probably to 7-3/4 percent or something like that [for M1].

CHAIRMAN VOLCKER. Mr. Morris, we're left without a comment from you.

MR. MORRIS. Well, I would buy alternative B. I think Roger has made a very good point that the borrowing target ought to be higher than \$300 million--more like \$400 million.

MR. PARTEE. Well, I think we need to develop fairly promptly a view as to the kind of weight we give to seasonal borrowing. It's not zero and it's not a hundred; it's something in between. Of course, we could have an unusual increase in seasonal borrowing--maybe not between now and the next meeting but between now and midyear--and we need to know how to evaluate that if it occurs.

CHAIRMAN VOLCKER. [Unintelligible] we've really had a different program for seasonal borrowing, we'd have to take account of it. It's going to develop in the next five weeks.

MR. AXILROD. What we present, of course, always assumes a normal seasonal in a sense.

MR. PARTEE. Yes. Well, this just reminds me that it's something we ought to be looking at.

CHAIRMAN VOLCKER. Well, in this case, we seem to have a great degree of unanimity about alternative B, whatever that means. Let me interpret alternative B. Borrowing is roughly around \$300 million. It has been running a little above \$300 million, actually, so I would think alternative B is consistent with something like \$300 to \$400 million, depending upon the tone and feel of the markets, including the exchange market. If the evidence accumulated in the next few weeks that we're distinctly above it, the tendency would be to tighten a bit.

MR. PARTEE. Above on the aggregates?

CHAIRMAN VOLCKER. Yes, above these numbers for the aggregates. But probably we would not move very aggressively at this point. It sounds fine in concept. If this happened coinciding with weak business news and a strong dollar, I would have some question about it. At least at this point I would interpret this as not absolutely automatic if those two condition arose. But the presumption would be in that direction. The prospects of easing, I think, are substantially less in the sense that we would have to have slower growth in the aggregates than suggested in alternative B plus greater concerns about the business picture than have been expressed around this table. That's what I would interpret alternative B to mean. Does that differ widely from what anybody else thinks? I

attempted to incorporate this into a somewhat rewritten directive but I don't have any copies of that.

MR. AXILROD. Yes, we have that.

CHAIRMAN VOLCKER. You might take a look at it.

MR. PARTEE. I think Lyle's point was good about those modifiers on the business situation.

MR. GRAMLEY. I have a suggestion for a way of dealing with that that's fairly neutral, and that is--

CHAIRMAN VOLCKER. Well, I rewrote the whole thing. I gagged a little at saying "maintain" the degree of reserve pressure when it's something of a euphemism to say we have any reserve pressure at the moment.

MR. MORRIS. It should read: "the absence of reserve [pressures]."

MR. PARTEE. "The same reserve posture."

CHAIRMAN VOLCKER. Well, I made it "maintain reserve conditions." Presumably, this would be--what do we have there: 8 percent and 10-1/2 percent and 9-3/4 percent? Those are awfully precise fractions. I doubt whether we generally put "3/4s" in there, do we?

MR. AXILROD. Not really. We get hung up with maintaining differences among the alternatives consistent with what our model tells us.

MR. PARTEE. [Unintelligible] number of models you look at.

CHAIRMAN VOLCKER. I would be sorely tempted to say 10 percent for both of them, just to round them off.

MR. PARTEE. Wouldn't it require quite a substantial slowing of M2 growth to get 10 percent, Steve?

MR. AXILROD. Well, it slows to 9 percent and then to 7-3/4 percent to get 10-1/2 percent.

MR. PARTEE. January was pretty high?

MR. AXILROD. January was 14-1/2 percent.

MR. PARTEE. 14-1/2 percent.

CHAIRMAN VOLCKER. Technically, we could separate out the M1, M2, and M3 and say something like: "Growth of M1 would be at an annual rate of around 8 percent, and growth of M2 and M3" etc.

VICE CHAIRMAN CORRIGAN. The only word I stumble over a bit is "limited." Could that be made "gradual" or "moderate" or--

MR. PARTEE. I do too. Maybe "some." And then for the easing sentence [rather than] "might be acceptable," I think we ought to say "would be acceptable" under those conditions you have specified.

MR. WALLICH. Well, this is [unintelligible] the fact that I think of it in a deliberately asymmetrical manner. Wouldn't "might" and also the word "substantially"--

MR. PARTEE. Yes, I thought "substantially"--

MR. MARTIN. I think it should be symmetrical given the unknowns we're mulling over here.

MR. BLACK. I favor symmetry but if we must be asymmetrical, I think this is the right direction.

MR. WALLICH. That's right.

MR. PARTEE. Well, I didn't mind the "substantially slower growth" but then might "be acceptable in the event of substantially slower growth in the monetary aggregates, sluggish growth in economic activity, and continued strength of the dollar"? I thought "might" was perhaps a little reserved. Lyle, I think that does take care of your problem.

MR. GRAMLEY. Yes. Where the term "sluggish growth" falls now, since it's second, it doesn't seem to say that we've failed to notice what has happened so far.

CHAIRMAN VOLCKER. We could put in a sentence on the aggregates and say something like this: "Should growth in M1 appear to be exceeding an annual rate of around 8 percent and M2 and M3 a rate of around 10 to 11 percent."

MR. MARTIN. 12 percent down from 14--

MR. PARTEE. 10 to 11 percent is okay. I think that is reasonably stated. We're going to get a slowing in M2 growth; there's no doubt about that. But I think it will be hard to get it within the quarter when one month is 14-1/2 percent.

CHAIRMAN VOLCKER. I don't know how we should describe this increase in reserve pressures. I was looking for a word that said we weren't going to be terribly aggressive about it in the next five weeks. Given the conditions, a "modest increase"--

MR. PARTEE. "Some increase" is pretty indefinite.

CHAIRMAN VOLCKER. "Some" isn't necessarily "modest." What word do we typically use? It's probably "some," isn't it?

VICE CHAIRMAN CORRIGAN. I think it is "some."

MR. BALLE. How about "some limited"?

MR. BOEHNE. I think "limited" captures the spirit of what we've been talking about. If we did anything terribly aggressive, I would think that we'd want a consultation.

VICE CHAIRMAN CORRIGAN. Maybe it's a matter of semantics. ["Limited" sounds as] if there is a predetermined point beyond which we would not go in any circumstance. It's partly the semantics of it that I'm reacting to. I am not talking about being aggressive or anything like that, but I think a word like "gradual" or "some" is just more in [tune] with the kind of approach we take to these things.

MR. MARTIN. I think the message is that we're giving this a little tap; we're not letting the 10 to 12 percent run but we're not reversing course. Isn't that what we're trying to get at? That's what "some" says.

CHAIRMAN VOLCKER. Well, in a sense. But I think "some" is probably what we use all the time when we've made big changes.

MR. PARTEE. It says "pressures." We could change it to "conditions" as it has previously been.

CHAIRMAN VOLCKER. We can't say "increases in conditions."

MR. PARTEE. Well, I was going to add--you may not care for this--that we could say "some snuggling up."

CHAIRMAN VOLCKER. You're right. I don't care for that.

MR. GRAMLEY. It sounds a little obscene.

CHAIRMAN VOLCKER. Well, it has been pointed out to me that the typical version uses "somewhat greater or somewhat lesser."

MR. GRAMLEY. Well, so long as we all understand what's going to happen. This language is going to come out after the fact anyway. I think the point to be made is the one that Jerry made: that if we say "limited," the public may say that we had a certain degree specified and would go no further beyond that. We still want to maintain the idea that we have the ability to respond to what is happening.

VICE CHAIRMAN CORRIGAN. It's conveying that sense of fluidity, even if we don't--

MR. PARTEE. Actually, the suggestion "some limited" is rather better with respect to that. "Some limited increase in reserve pressures" doesn't have the precision.

CHAIRMAN VOLCKER. We could go with "modest" or "some modest."

MR. MARTIN. We would have to say "some modest."

CHAIRMAN VOLCKER. That's more than "modest."

MR. GRAMLEY. What about saying "reserve pressures would be increased somewhat, particularly if business activity"--

CHAIRMAN VOLCKER. Well, that sounds like more to me. I understand it won't be published until later, but that's what we always say.

MR. MARTIN. I think the word "modest"--. Say "modest increases would be sought."

CHAIRMAN VOLCKER. Well, if this is where we are, do we make that sentence "Should growth in M1 appear to be exceeding an annual rate of around 8 percent and M2 and M3 a rate of around 10 to 11 percent during the period from December to March, modest increases in reserve pressures will be sought, particularly" etc.? And then say "lesser restraint on reserve positions would be acceptable" and keep the federal funds range at 6 to 10 percent. Is that where we are? This does imply, unless I'm wrong, that we will remain above this cone.

MR. AXILROD. Oh yes.

CHAIRMAN VOLCKER. And in all cases, I guess.

MR. AXILROD. If the cone is 4 to 7 percent, it comes out as a projection that by March the level is something like \$3-1/2 billion above it.

MR. BALLE. Mr. Chairman, would you consider adding some words to the directive, such as you talked about a little earlier, to indicate that conditions might arise where we wish to be above that limit?

CHAIRMAN VOLCKER. I think this implies that we would be above the upper limit. But I will return to that in the longer-term decision. I think this implies--and we might as well say it--that we expect to be above the upper limit of the cone in the early part of the year.

MR. BALLE. That would take away a lot of the uncertainty and speculation and guesswork in the market.

CHAIRMAN VOLCKER. Well, I think we should say it, if we have this kind of short-term directive. I think I'd probably say it in testimony.

MR. GRAMLEY. It's much better to say it in the testimony because that way the message gets to the public and you want it to. Otherwise, it's too late.

MR. MARTIN. I think we should say it in both places.

CHAIRMAN VOLCKER. Well, I worry about this in the testimony: I don't know how to word it. We haven't exactly tightened but in the process of stopping the ease we're a little snugger than we were. I don't know quite what word to use to convey the nuance. It's hardly a snug.

MR. BLACK. If you want to get a chuckle, say it just that way.

MR. MARTIN. I thought the term of art this season was "tilt." We have removed the tilt.

MR. KEEHN. If we're contemplating a shift to parallel lines, do you have to spend a lot of time talking about where we are in relationship to the cone?

MR. PARTEE. I think we have to leave the cone.

CHAIRMAN VOLCKER. Well, it's implied. I take it we're ready to vote on this. Then we'll have coffee.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
President Balles	Yes
President Boehne	Yes
President Boykin	Yes
Governor Gramley	Yes
President Horn	Yes
Governor Martin	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Seger	Yes
Governor Wallich	Yes

CHAIRMAN VOLCKER. I must say just for the record, and I'm sure it's apparent to all of you, that the exchange market has more prominence in this directive than it has ever had. It has been mentioned in recent [announcements of] discount rate changes, but--. Let's have coffee.

[Coffee break]

CHAIRMAN VOLCKER. Somehow I didn't get a great message from outer space as to how to resolve this long-range target while eating doughnuts. I continue to believe that what comes the closest to capturing the central tendency is leaving the 4 to 7 percent. We could raise M2 and M3--at least the upper ends--by a 1/2 point, if that makes people feel happier. We would make some note that growth is going to be running above the cone. I don't think we have to say that in the directive; I could say in the testimony that we're running ahead of the cone in the early part of the year and we expect that. I think that's normal and reasonable under all conditions. And we would have some reference, probably, in the directive that it might be acceptable to be in the upper part of the range, but make it short of saying we're aiming for that. I don't think we have to say what we're aiming for, conclusively, 9 months from now. We review it again at midyear. If we really find that velocity is not right, then we may have to change the target in the middle of the year; we've had some experience in doing that. But, meanwhile, we give a reasonable signal. And it all comes against the background that I would like to give a little more confident view as to the inflation outlook, which I will for myself [in my testimony]. Therefore, it makes all these numbers fit better.

So, I will try again: something like 4 to 7 percent, with a modifier in the directive, which we don't have precise language for

yet; I'm fairly indifferent on M2 and M3 but if it really makes people feel better to add another 1/2 point, I don't think that does us any grave damage one way or the other; total credit looks awfully high to me, but I guess we could leave it where it is. Let's see whether we can proceed on that basis. Let me ask a preliminary question. A number of people said they would rather have 4 to 7-1/2 percent or 4 to 8 percent but they may or may not have wanted another 1/2 point on M2 and M3. Does it make any of those people happier to have another 1/2 on M2 and M3?

MR. MARTIN. I'd much prefer it on M1, Mr. Chairman.

CHAIRMAN VOLCKER. That's not what I asked.

MR. BLACK. We could have it on M1 and drop it from M2 and M3.

MR. MARTIN. I could go along with that.

CHAIRMAN VOLCKER. Well, I think the trouble with that is that it's probably contrary to where the probabilities lie. The probabilities are that M2 and M3 are more likely to exceed [the upper ends of the ranges] than M1.

MR. PARTEE. But I would like to point out to you, Paul, that the staff's M1 projection under alternative B is for growth for the first quarter over the fourth quarter of 9.2 percent. If that's at all right, the 7 percent is a considerable constraint for the remainder of the year.

CHAIRMAN VOLCKER. Well, I don't know what it means for the middle of the year mathematically.

MR. PARTEE. Well, for three more quarters it means about 6 percent.

CHAIRMAN VOLCKER. There's no question it means less than 7 percent.

MR. AXILROD. About 6 percent.

CHAIRMAN VOLCKER. About 6 percent?

MR. AXILROD. About 6 percent or [just] below that.

CHAIRMAN VOLCKER. Sure, it takes all three--

MR. PARTEE. Yes, right.

MR. BALLE. Mr. Chairman, one thing that might help--

CHAIRMAN VOLCKER. That is more, I would point out, than we had all of last year when the GNP was rising by 5-1/2 percent.

MR. PARTEE. It could happen.

MR. BALLE. Mr. Chairman, one thing that might help all those who are worried about the 7 percent ceiling would be what you

propose on the matter of the so-called parallel lines or the bands. My concern, specifically--because we have a money market model which gives results very similar to those of the Board staff's monthly model--is that the model shows money growth for some months ahead at double-digit rates. To keep from getting that, we estimate we have to put short-term rates up at least 200 basis points or thereabouts. But if we were to adopt the bands, that would take care of the problem early in the year--in the sense that we would be above the cone but not above that parallel line.

CHAIRMAN VOLCKER. I certainly think we should be above the cone in these early months. Now, just how do we draw it? We can draw parallel lines; we can draw solid-line parallel lines and dotted-line cones; we can draw dotted-line or solid cones and dotted-line bands.

MR. GRAMLEY. We could even use colors!

CHAIRMAN VOLCKER. We can draw the kind of thing that I drew, which is the way I tend to think of it. It doesn't make much difference in where the line actually falls. I'm open to any of those variants. I'd draw the parallel lines without the cone, if that's--

MR. WALLICH. I think the discussion shows the danger of the band. The band allows you to go at any rate of speed during the early months.

MR. PARTEE. And they have to slow down later.

MR. WALLICH. While I would ordinarily say it doesn't matter because you know what you're doing, here we're talking about it as though it really made a difference. We give ourselves more leeway; we use it right away.

CHAIRMAN VOLCKER. For a good reason, though, I would say. In this particular case, we ended up with a slowdown in M1 growth last year, so it's quite natural--it's a characteristic of the band--that we would also be happy with an extremely low growth in the first quarter, if you took it literally. We're not going to get that, but with just the band itself M1 growth would still be within the band if we had zero growth, I suppose--or close to it--for this quarter.

VICE CHAIRMAN CORRIGAN. The reverse is also true, though. If, as John says, we had double-digit M1 growth for several more months running, you can draw your lines any way you want and you have one heck of a problem.

CHAIRMAN VOLCKER. None of this changes the fact that what we're fixing is where we'd like to be at the end of the year. Indeed, I don't think it makes an enormous difference whether it is 1/2 percentage point higher at the top; it's visual. We're talking about \$2-1/2 billion of money supply, right?

MR. MARTIN. The band is a better way to communicate. It essentially expresses what we do.

CHAIRMAN VOLCKER. I have no problem with a band. I assume that at the least we would draw a band along with the cone.

MR. MARTIN. Right.

CHAIRMAN VOLCKER. Since there has been discussion about it, just for the purpose of elucidating how the two things look, at a minimum we would draw them both.

MR. BALLE. And that would help.

MR. GUFFEY. Well, we had the same problem at this time last year: January had growth in the double-digit range and we were above the cone until the end of the first quarter as I recall. I don't know how you explained it then but it didn't seem to create great problems.

CHAIRMAN VOLCKER. Well, does anybody have some striking suggestion as to how to draw the picture that they urgently want to bring to our attention? Left to my own devices, I will draw some kind of a band--a lopsided band or something--along with the cone.

MR. GRAMLEY. It will become known as the Volckergram.

MR. BLACK. With a truncated band.

MR. WALLICH. If you connect the extreme points of last year's cone and this year's cone and make that the band, you'll find that you have a very low rate of growth in that connecting line. You would be going from something that rose 8 percent to the next cone, which would be rising 7 percent. And the connecting line, if that's the top of the band, will be a lot flatter than the upper side of either cone.

MR. PARTEE. A little flatter.

CHAIRMAN VOLCKER. It will be a little flatter than a parallel line, but hardly enough to be discernable.

MR. WALLICH. Right.

MR. PARTEE. Probably 1 percent flatter.

CHAIRMAN VOLCKER. It would be 1 percent flatter; well, it would be $\frac{3}{4}$ of a percent flatter. And since we're not up there at the beginning anyway, it wouldn't make much difference. The simplest thing to do is probably a compromise between them. I might draw a truncated line--draw the cone with just a top parallel line.

MR. BALLE. I'd settle for that.

MR. BLACK. Where are you thinking about beginning the line? You explained that yesterday and I thought I understood but I wasn't quite certain.

CHAIRMAN VOLCKER. Well, I'm not saying that now. We would just make it $\frac{3}{4}$ of a percent different. If you draw parallel lines, they would both rise at a $5\frac{1}{2}$ percent rate of speed.

MR. BLACK. Right.

CHAIRMAN VOLCKER. The bottom part of that would be out of sight; nobody wants to go there initially. The only modification I had was that instead of a parallel line, I'd draw it back to the fourth quarter.

MR. PARTEE. Target.

CHAIRMAN VOLCKER. [The fourth-quarter] target, which would be $3/4$ of a point higher because we ended up below the midpoint.

MR. BLACK. Yes, that's what I understood you to say.

CHAIRMAN VOLCKER. And that's all. The only rationale is that I find it easy to explain. I say that that was last year's target and we presumed we would have been satisfied to be there. Assuming we were satisfied to be there, we want to have some continuity to the next year. We know where we want to be at the end of this year, we decided where we wanted to be at the end of last year, and that's just a line that happens to connect those two targets that we happened to agree upon. It's no big deal, and maybe it does--

MR. PARTEE. It creates lots of room, all right.

MR. WALLICH. It sure does.

CHAIRMAN VOLCKER. You're looking at these early months since--

MR. PARTEE. Yes, and we're well within it.

CHAIRMAN VOLCKER. Well, we're not all that much within it, are we?

MR. PARTEE. Well, if I understand the way you're going to draw it, we're a good deal more within it than with parallel lines.

MR. AXILROD. Yes, it's more than with parallel lines.

CHAIRMAN VOLCKER. It would be $3/4$ of a percentage point more within it than--

MR. PARTEE. Well, that is just connecting the points here. When I look at the--

CHAIRMAN VOLCKER. You're unquestionably right in direction; I just don't know how far it will go. I'd have to look at it. Where are these great pictures [in the Bluebook]?

MR. PARTEE. M1 is right after the full page of tables.

MR. MARTIN. Two pages beyond page 10.

CHAIRMAN VOLCKER. That's the way I drew it before; that's right. In the fourth quarter we're going to be $3/4$ of a percentage point above the parallel line and it would get progressively less. I don't know what it would be in the first quarter; I suppose $5/8$ ths of a percentage point or so.

MR. WALLICH. Well, it'll be more comfortable throughout the year as far as how high up we can go. As far as the rate of growth we can have, once we reach it, it'll be less.

CHAIRMAN VOLCKER. It won't be more comfortable in the fourth quarter.

MR. WALLICH. There is more room to go up. There isn't more room once you're at the top.

MR. GRAMLEY. You can always turn the picture sideways, though, Henry!

MR. BLACK. Or upside down!

MR. MARTIN. But only if you have a semi-log scale.

CHAIRMAN VOLCKER. You come out the same place in the fourth quarter.

MR. AXILROD. Mr. Chairman, I think Governor Wallich is saying that if you reach the top of the parallel line you have to grow 5-1/2 percent, no more than that; if you reach the top of the higher line you have to grow 4-1/4 percent or something. These are rough numbers.

CHAIRMAN VOLCKER. That is correct. It's 4-3/4 percent--

MR. PARTEE. Say we've had a couple of quarters of 9 percent growth; the arithmetic implication is that it is going to have to drop to 5 percent.

CHAIRMAN VOLCKER. I think all these implications are the same. Wherever you are in the first quarter, to meet the target at the end of the year growth has to slow down.

MR. MORRIS. Unless we rebase.

MR. PARTEE. Now, there might lie the basis for some compromise. We can go with the 4 to 7 percent on the understanding that we're going to increase it later.

CHAIRMAN VOLCKER. Well, I think clearly [unintelligible].

MR. PARTEE. I don't recall that we ever have, but I may be wrong about that.

MR. AXILROD. Yes, we did.

MR. MORRIS. We did.

CHAIRMAN VOLCKER. Oh yes.

MR. PARTEE. We rebased, but did we ever raise it?

VICE CHAIRMAN CORRIGAN. Yes, we did both.

MR. MORRIS. We eliminated it for one year.

MR. GRAMLEY. In mid-1983 we--

VICE CHAIRMAN CORRIGAN. We rebased and raised [the M1 range].

MR. GRAMLEY. We rebased and raised the target from 5 to 9 percent.

MR. BLACK. We rebased on the second quarter.

MR. GRAMLEY. And accepted the overrun in the first half.

MS. HORN. We rebased and we respecified.

MR. GRAMLEY. We made a tremendous change in mid-1983.

MR. BLACK. The base became the second quarter.

MR. GUFFEY. And then we used it as a monitoring--

MR. PARTEE. That's right, we did; rebasing made a big difference.

CHAIRMAN VOLCKER. I think we always reserve this right and we have done it. Suppose it ended up that business is sluggish, inflation is doing fine, and the dollar is very strong, but liquidity preferences are high and money growth is running high. We said money growth is expected to run high in the first quarter of the year; if at the middle of the year we say we don't think it's reasonable for it to go down, we have to raise the target. What I would hope would happen is that inflation will be less, we will get nice orderly growth, that this trend appears in M1--which it may or may not--and that everything works out just copacetic. Who knows? How much do you think the consumer price index is going to be affected by this orange and vegetable situation?

MR. KICHLINE. I think we have 4-3/4 to 5 percent for food prices in the first quarter. Our CPI projection, let's see--

VICE CHAIRMAN CORRIGAN. While the staff is looking that up, I would just note that one of the things that could really help the price outlook is some relaxation in these Japanese automobiles quotas because one of the troubling things about prices even now is the way the auto manufacturers are sneaking in all these price increases.

CHAIRMAN VOLCKER. Just as a matter of curiosity, the same thing occurred to me--

MR. KICHLINE. We are expecting a CPI of 3-1/2 to 4 percent in the first quarter. Offsetting the food price rise is an expected price decline in energy of 4 percent.

CHAIRMAN VOLCKER. How much of a bulge do you have in the food prices?

MR. KICHLINE. How much of a rise in food? Food prices rose 2-3/4 percent in the fourth quarter and we have them up to 4-3/4 percent, so that's a 2 percentage point increase. Energy prices were

about flat--up a percent--and we have them down 4 percent, so they ought to be offsetting factors in the first quarter.

CHAIRMAN VOLCKER. Are Japanese cars in the consumer price index?

MR. KICHLINE. Conceptually, yes. They expanded the models some years ago and I used to know that and I don't remember. But yes, conceptually.

MR. GRAMLEY. I wouldn't look for much price relief from raising the quotas. The quota increase probably will be quite small. And the excess demand for Japanese cars is so great that I think at existing prices they could just ship a few more and that's about it.

VICE CHAIRMAN CORRIGAN. That's probably true.

CHAIRMAN VOLCKER. I suspect that's right. But suppose they take the quota off?

MR. GRAMLEY. Well, my sense is that the Japanese would be so reluctant to risk the possibility of a reimposition of quotas that they would increase their shipments to the United States in quite modest amounts. I would doubt seriously, if we had a removal of the quotas, that we would see an increase in Japanese shipments of more than, say, 10 percent.

MR. MARTIN. But don't forget that the South Koreans are now coming onto the market. [Unintelligible] and some of these other companies are coming on strong. And the [cars are priced] at \$6,000 and under.

MR. GRAMLEY. Yes, I know. I was just--

MR. PARTEE. Favorable prices.

MR. GRAMLEY. --making the comment solely with respect to Japanese quotas. The shipments from South Korea and so on are going to increase anyway. But the shipments from Japan I don't think are going to increase very much.

CHAIRMAN VOLCKER. How big a car do they put in the consumer price index?

MR. KICHLINE. I have somebody on the staff who could give you the [specifics] in all sorts of ways, but I'm not the person.

CHAIRMAN VOLCKER. You're not the man. But they don't price the expensive ones, do they?

MR. PARTEE. Not the really [expensive ones].

CHAIRMAN VOLCKER. I don't know what they call expensive.

MR. PARTEE. Cadillacs.

VICE CHAIRMAN CORRIGAN. I think we could guarantee that what they would call expensive would be different from what you'd call expensive.

MR. PARTEE. Actually, you'll find that any car is expensive.

CHAIRMAN VOLCKER. I'm afraid so.

MR. PARTEE. \$10,000 or more.

CHAIRMAN VOLCKER. Well, I don't hear any bright ideas about how to draw these parallel lines. If I don't hear any stronger ideas right now, I will reserve that prerogative unto myself with the understanding that there's going to be some kind of parallel line picture. But I will go back and ask two questions. Are those who want higher ranges at all consoled by making M2 and M3 higher? And are those who don't want higher numbers distressed by making M2 and M3 higher?

MR. MARTIN. It depends on whether we can agree with regard to language.

CHAIRMAN VOLCKER. Well, let's look at the language. Steve has given me a modified sentence. I don't know whether you'll like it: "The Committee agreed that growth in"--

MR. MARTIN. They ignore the separate--

CHAIRMAN VOLCKER. It continues the first page. Change the "M1" to "monetary aggregates" and otherwise the first part remains the same: "The Committee agreed that growth of the monetary aggregates in the upper part of their ranges for 1985 may be appropriate, provided that inflationary pressures remain subdued and depending on velocity trends." If we use that kind of language, it just reads a little more smoothly to me to say "may be appropriate depending on velocity trends and provided that..."

MR. MARTIN. It's important to make that comment with regard to velocity. That's been a good deal of the substance of our discussion. And John Balles has been [suggesting] language with regard to the lagged effects of the interest rate drop in the last year. Whether that's appropriate--.

CHAIRMAN VOLCKER. Well, I think that's broadly encompassed in this term "velocity trends." It may not be a trend, but in this context we're not really talking about it depending on long-term velocity trends; what we mean is depending upon velocity this year.

VICE CHAIRMAN CORRIGAN. We're talking about short-term velocity rather than long-term.

CHAIRMAN VOLCKER. One could say "depending on velocity developments."

VICE CHAIRMAN CORRIGAN. "Developments" is a better word.

MR. PARTEE. And if we generalize it to say "monetary aggregates" that may be appropriate.

CHAIRMAN VOLCKER. Yes.

MR. GUFFEY. It picks up M2.

CHAIRMAN VOLCKER. "Depending on developments with respect to velocity and provided that inflationary pressures remain subdued." How do you like that language?

MR. GRAMLEY. Poetry.

MR. BALLE. Sorry, Mr. Chairman, but are there some words in that--we don't have it in front of us--that say something about being above the cone or whatever?

CHAIRMAN VOLCKER. Well, I wouldn't say that in the directive. But it would be said; it's implicit in the decision we have just made. We're talking about a fourth-quarter target here and it sounds a little awkward--I don't object to it, but it seems to me totally unnecessary--to say here that consistent with that fourth-quarter target we intend to be above the cone in the first quarter.

MR. BALLE. Oh, I see now.

CHAIRMAN VOLCKER. I think that point should be made; I just don't see that it's necessary here. I have no objections to saying it here, but it just seems rather complicated to me.

MR. PARTEE. You wouldn't be prepared to say monetary aggregates in the upper part of their ranges or above? Well, there are two great provisos.

CHAIRMAN VOLCKER. No, but I think I could say something about that in the testimony. I don't think we should set a range and say we might be above it. We might. We haven't been within the ranges all that consistently, but it's rather peculiar to say that in the directive.

MR. MARTIN. That's why 7-1/2--

CHAIRMAN VOLCKER. I have no problem with saying: "Obviously, we'll look at these at midyear; we expect to be above in the first half of the year and if velocity were really slow we'd have to look at this range again at midyear." I think we probably ought to say that. What about M2 and M3? Let me examine the proposition this way. I am assuming this language and--. Where are we on these three ranges? I found myself testifying the other day unable to remember what the ranges were. At least psychologically that tells you something.

VICE CHAIRMAN CORRIGAN. Page 5.

CHAIRMAN VOLCKER. What's the preference for [upper limits of]: (a) 7, 8-1/2, and 9 percent, which is exactly the same as alternative II, as opposed to (b) 7, 9, and 9-1/2 percent?

MR. PARTEE. Opposed.

CHAIRMAN VOLCKER. You want the (b)?

VICE CHAIRMAN CORRIGAN. Or whatever it--

CHAIRMAN VOLCKER. Well, I didn't get around to asking the question!

MR. MARTIN. Oh, I thought you said--

VICE CHAIRMAN CORRIGAN. You got a little overanxious over there!

MR. MARTIN. No, we're just quicker!

CHAIRMAN VOLCKER. I'm going to ask both. Option (a) is alternative II as shown [in the Bluebook]; (b) is 1/2 percentage point higher for M2 and M3. How many prefer (a)?

MR. GRAMLEY. What are you talking about now?

CHAIRMAN VOLCKER. Option (a) is alternative II.

MR. PARTEE. Yes.

VICE CHAIRMAN CORRIGAN. As is.

MR. MARTIN. As is.

CHAIRMAN VOLCKER. All of this has the language in the directive.

MR. BALLE. There is only one hand up, Mr. Boykin's.

CHAIRMAN VOLCKER. Now, (b) with a 1/2 percentage point higher on the upper end of M2 and M3.

MR. RICE. Well, I'm not [for] M2.

VICE CHAIRMAN CORRIGAN. I could live with your (b).

CHAIRMAN VOLCKER. Well, the in-between course is raising M3.

MR. PARTEE. I think M2 is likely to give us trouble and I would want that upper end up a little. I don't care what we do to M3 because we don't pay any attention to it.

MR. RICE. No; that's why it's harmless--

CHAIRMAN VOLCKER. I don't think that's 100 percent true.

MR. PARTEE. 99 percent.

CHAIRMAN VOLCKER. So, we use 7, 9, and 9-1/2 percent [as upper limits] and 9 to 12 percent [for credit], I guess. Does that have the largest amount of support? It does raise a question in my mind: If we raise those M2 and M3 limits, maybe we should go back to just talking about M1 in that sentence we just wrote.

MR. MARTIN. We might still have a problem with M2.

CHAIRMAN VOLCKER. Yes, we could but it--

VICE CHAIRMAN CORRIGAN. Why don't you see who could accept your (b) but not necessarily prefer it.

MR. PARTEE. Yes, who can live with it?

MR. AXILROD. Our point estimate of M2, which may be a little low, would only be a half point above the midpoint of that 6 to 9 percent. It could well be 8-1/4 percent or higher.

MR. GUFFEY. But it's still well within the range.

MR. AXILROD. Yes. As I say, it's only a half point above the midpoint.

MR. PARTEE. Well, your point estimate is already in the upper part of the range. That's another way of putting it.

MR. AXILROD. Well, yes.

CHAIRMAN VOLCKER. Your point estimate is what?

VICE CHAIRMAN CORRIGAN. 8 percent.

MR. AXILROD. 8 percent at the moment. That requires quite a slowdown in the subsequent quarters.

VICE CHAIRMAN CORRIGAN. Keep in mind that that moment is 11:50 a.m. By 12:00 noon it may be something else!

MR. MARTIN. 10 percent!

MR. PARTEE. We count [deposits at] nonbank banks in the monetary aggregates, don't we?

MS. SEGER. Those that have checking.

MR. PARTEE. [Unintelligible.]

MR. BLACK. Chuck, only those that take demand deposits.

MR. PARTEE. What?

MR. BLACK. Ones that aren't supposed to take deposits--

CHAIRMAN VOLCKER. This actually makes M2 and M3 higher than we had them last year. What were [the ranges for] last year? I don't guess there's any--

MR. STERNLIGHT. Both were 6 to 9 percent.

CHAIRMAN VOLCKER. 6 to 9 percent for both of them? So we can make M2 the same and M3 a little higher.

MR. GRAMLEY. If we change it once more, I'm going to wear a hole in this paper!

CHAIRMAN VOLCKER. Let's try that (b): 7, 9, and 9-1/2 percent; and 9 to 12 percent. How many go along with that? Well, I think that's as close as we're going to come. Let's vote on that.

MS. SEGER. Just to educate me, if we go with the 4 to 7 percent for M1, can you tell me why we can't tie it to the midpoint of the fourth quarter--that is, the range for last year that we shot for?

CHAIRMAN VOLCKER. Well, we can, but we decided not to.

MR. PARTEE. It's just that it produces so much rigidity to have that as a precedent for doing it in the future. It's like having a monetary rule.

MS. SEGER. Making that up was one of the reasons why I wanted to have a wider band. So, I can go with the narrower band if it's calculated from a higher level.

CHAIRMAN VOLCKER. Well, that is the reason in my mind for indicating that we might be happy in the upper part of the range, based upon what we know now. All right. Do you know what you're voting on?

SPEAKER(?). Not now.

MR. GRAMLEY. I think so.

CHAIRMAN VOLCKER. 7, 9, and 9-1/2 percent upper limits [for M1, M2, and M3, respectively], 9 to 12 percent [for credit], and the sentence as we talked about it in the directive. There's nothing else in the language that raises a question is there?

MR. BALLE. And with a Volckergram.

MR. GRAMLEY. He's liable. We have already given him the authority to make his pictures anyway he wants to including colors, dots--

CHAIRMAN VOLCKER. On the understanding that there will be something like a parallel line on the [unintelligible].

MR. BERNARD. Your reference is to all the aggregates and not just M1 in this sentence?

MR. PARTEE. I think it ought to say aggregates; it ought to be generalized. If they don't happen to be there--well, they won't be there.

CHAIRMAN VOLCKER. Okay.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
President Balles	Yes
President Boehne	No
President Boykin	Yes
Governor Gramley	Yes
President Horn	Yes

Governor Martin
Governor Partee

No
Reluctantly, yes

MR. PARTEE. Could you put in that "reluctantly"?

VICE CHAIRMAN CORRIGAN. Somewhat reluctantly?

MR. WALLICH. Limitedly.

MR. BERNARD.

Governor Rice
Governor Seger
Governor Wallich

Yes
Yes
No

CHAIRMAN VOLCKER. All right. I guess we have nothing else to do. The Secretary points out to me that we had better modify that sentence about retail sales registering a large increase in November and remaining at a higher level in December since it's no longer true. The language he suggests is: "Total retail sales rose moderately in January following a decline in December." With all that [unintelligible].

MR. PARTEE. [Unintelligible.]

CHAIRMAN VOLCKER. You have a chance to go back and redo your [Humphrey-Hawkins] projections if you do that within a day or two. I won't register my concern about the price numbers, except that I'm reminding you that I registered it.

MS. SEGER. Are we supposed to make a certain assumption about the value of the dollar to be consistent?

CHAIRMAN VOLCKER. Yes, I think the assumption would be stated as: the value of the dollar will not be substantially changed. I think what we said last time was that its value would not be outside the range of trading in recent months or something like that. We could have an 8 percent decline and not be outside that range.

MR. GUFFEY. The assumption for the money growth is at the midpoint or--?

CHAIRMAN VOLCKER. I really don't know. The assumption for money at wherever you want to make it within that range, I guess.

MR. GUFFEY. It makes quite a difference.

MS. SEGER. The staff have [M1] at 6-1/2 percent in their assumptions.

MR. GUFFEY. Well, that's the point.

CHAIRMAN VOLCKER. We can proceed to other things [and adjourn now].

END OF MEETING